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OVERSIGHT OF THE INTERNATIONAL MONETARY FUND

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

PROGRESS ON REFORM OF THE INTERNATIONAL MONETARY FUND, FOCUSING ON THE GROWING ROLE OF INTERNATIONAL DEBT SECURITIES, THE INCREASE IN VOLUME OF PRIVATE CAPITAL FLOWS, AND THE INCREASING INTERCONNECTION BETWEEN FINANCIAL MARKETS

JUNE 7, 2005

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C O N T E N T S

TUESDAY, JUNE 7, 2005

WITNESSES

OVERSIGHT OF THE INTERNATIONAL MONETARY FUND

TUESDAY, JUNE 7, 2005

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Mike Crapo, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. This hearing will come to order.

Good morning. This is the hearing of the Committee on Banking, Housing, and Urban Affairs, Subcommittee on International Trade and Finance, on International Monetary Fund oversight. Today, as the title of our hearing indicates, we are here to discuss the International Monetary Fund. As the largest contributor of the IMF, the United States has the responsibility to ensure that our resources are being used wisely. The United States, with the urging and support of the U.S. Congress, has been a key supporter in moving the IMF in the right direction in terms of getting more accountability and understanding of what is happening inside the IMF.

I would like to recognize and thank our witnesses for the significant contributions they have all made in making this happen. None of any of this would have been possible without the creation and hard work of the International Financial Institutions Advisory Commission and the continued pushing and prodding from the Treasury Department.

Although it is important that we recognize the real progress that has been made, we are not yet done. More needs to be done, and it is my hope that today's hearing will further demonstrate what progress we have made and what progress we need to make in the future. This will help us to determine what specific measures need to be addressed next.

The other main issues before us today are Argentina's attempt to conclude a new debt repayment agreement with the IMF, China's 10-year-old fixed exchange rate between the dollar and the yuan, and a potential IMF gold sale as a means of financing additional IMF debt reduction. These are significant challenges, and I look forward to a thorough discussion of these issues as well.

For our first panel today, we welcome Randal Quarles, the Acting Under Secretary of the Treasury for International Affairs. In this capacity, Mr. Quarles advises the Secretary of the Treasury on U.S.

participation in the international financial system, including subjects such as financial regulation, macroeconomic policy, exchange rate policy, trade and investment, and our participation in the International Monetary Fund and the World Bank, among other institutions. Prior to his most recent appointment at the Treasury Department, Mr. Quarles served as the U.S. Executive Director at the IMF from August 2001 through March 2002.

Our second panel will include two witnesses: Dr. Allan H. Meltzer, the Distinguished Professor of Political Economy at Carnegie Mellon University; and Dr. C. Fred Bergsten, Director of the Institute for International Economics, here in Washington, DC. Drs. Meltzer and Bergsten have extensive experience with the IMF. In November 1998, as a part of the legislation authorizing $18 billion of additional U.S. funding for the IMF, Congress established the International Financial Institutions Advisory Commission to recommend future U.S. policy toward the IMF and the World Bank, commonly referred to as the Meltzer Commission in reference to its Chairman, Dr. Meltzer. Dr. Bergsten also served on this Commission and co-authored the dissenting opinion. And I might note that we have had them before us in different contexts many times on these issues, and we appreciate both of them coming yet once again to help us continue to address these issues.

With that, we will begin with the testimony, and I would remind all of the witnesses that we have a clock. Because of the small number of witnesses, we have doubled the amount of time we traditionally allow for oral testimony, and so we are allowing each of you 10 minutes. We would encourage you to pay attention to the clock, though, because we do want to have a little time for questions and answers and some dialog.

Mr. Quarles.

STATEMENT OF RANDAL QUARLES
ACTING UNDER SECRETARY FOR INTERNATIONAL AFFAIRS,
U.S. DEPARTMENT OF THE TREASURY

Mr. QUARLES. Thank you, Chairman Crapo. I am very pleased to be here today to talk about our agenda as a shareholder of the International Monetary Fund. I will focus my oral remarks, with your permission, on efforts to modernize the IMF, and if my formal written testimony could be submitted for the record, I would appreciate that.

Senator CRAPO. Yes, the formal written testimony of each witness will be a part of the record.

Mr. QUARLES. And in that written statement, I have an update on Argentina's economy and their engagement with the IMF.

Reform of the IMF has been a high priority for the Bush Administration. The growing role of international debt securities, the increase in the volume of private capital flows, the increasing interconnection between financial markets, as well as the experience with crises in the 1990's, all underscore the need for action.

The Meltzer Commission helped provide impetus for this reform through the recommendations in their report of March 2000. Congress has been an active participant in this effort for change.

Over the last 5 years, the progress we have made on this front includes clearer limits and criteria for large-scale official sector

lending; a tighter focus by the IMF on its core macroeconomic areas of expertise; greater concentration on short-term financing; increased transparency in the IMF's operations, as well as in the national data of the member countries of the IMF; and adoption of collective action clauses as standard market practice in sovereign bond documentation to help promote orderly restructurings and reduce disruption.

I think those are all major steps forward, but as you noted at the outset, we are not prepared to relax our efforts. In response to calls from the United States and others, the IMF is now undertaking a review of its role and strategy for the medium term. We have several key priorities in this process:

One, strong surveillance and crisis prevention. We need to further tighten the focus and the selectivity of analysis that the IMF does to integrate more fully capital market and financial sector analysis into the daily life of the Fund.

A second priority for the United States has been the establishment of a new non-borrowing program. We strongly believe that the IMF needs a new tool to provide a structured engagement in support of strong economic policies where there is no need for borrowing. We have proposed such a mechanism. We have won the support of our partners in the G–7, and we expect that proposal to be taken up by the IMF's Board this summer. And demand for such an arrangement is already emerging from IMF member countries.

We are also looking for more effective engagement of the Fund with low-income members. Working with low-income countries to help them achieve macroeconomic stability is a vital part of the IMF's mission. At the same time, the Fund is not a development institution, and its financial operations should reflect its mission to provide short-term balance-of-payments financing. We have urged the IMF to undertake a close examination of its approach in low-income countries with a view to helping these countries achieve better economic results.

Helping low-income countries depends also on ending the lend-and-forgive cycle so that they can move into an era of sustainable debt. And the Bush Administration has put forward a bold proposal to provide up to 100 percent relief on International Development Association and African Development Fund loans to the heavily indebted poor countries. Action on this debt is critical to putting these poor countries on a sustainable path.

If there were any debt relief in the IMF, it would need to be financed from the existing resources of the IMF. We do not believe that gold sales—whether they were to be executed in the market or off the market—are necessary or warranted.

Before concluding, let me draw your attention to the issue of representation in the IMF, which is something else that we have been pressing in our strategic review.

The IMF is accountable to its 184 member governments through a weighted voting structure that is aligned with the countries' global economic standing. But change in the world economy over the last number of decades has outpaced that in the IMF, particularly given fast-paced growth in emerging market economies and given integration in Europe.

Secretary Snow has strongly signaled the need for the IMF structure to evolve. In our view, this is vital to maintaining the good will of its members and to preserving the centrality of the IMF in the global financial system.

Change will not come quickly or easily, but we believe the effort is essential to the long-term effectiveness of the institution.

And with that, I thank you for the opportunity to be here today, and I am looking forward to your questions.

Senator CRAPO. Thank you very much, Mr. Quarles, and we do appreciate the focus of the Treasury Department on the reform of the International Monetary Fund and your continued efforts to improve it.

I would like to first talk with you a little bit about Argentina. Argentina's default was unprecedented in size and for having the lowest recovery rate in history and for the process that has stretched the guidelines of sovereign debt negotiations. Argentina's sovereign debt restructuring has widespread implications not only for creditors but also for Argentina's long-term financial stability, developing country debt markets, and guidelines for future sovereign debt restructuring, as well as for IMF policies.

What lessons do you think we have learned by our engagement with the IMF and the Government of Argentina throughout this process?

Mr. QUARLES. Well, I guess the first thing I would say is that the learning process is not over. There will be continued engagement between the Fund and Argentina.

I think that one of the central things that we probably learned with respect to the debt restructuring process, which was the focus of your question, is that it is not necessary for the Fund to take an interventionist stance in debt restructuring between a country and its private creditors for that process to proceed. In our view, the debt exchange has now been completed, and Argentina needs to have a strategy for dealing with the remainder of its creditors. But the stance that the IMF has taken with our support throughout this process has been that the details of how that exchange is accomplished and the details of that strategy going forward are for Argentina to develop and for the creditors to evaluate, and that as a systemic matter the system will operate better going forward if parties do not feel that they are able to draw the official sector, and particularly the IMF, into mediating or directing those sorts of negotiations.

The IMF creates the macroeconomic framework in which the negotiations can take place, but it is not more interventionist than that.

Senator CRAPO. Let me interrupt there. In this case, Argentina has reached an agreement with 76 percent of its bondholders. The 24 percent that are outstanding still remain to be handled. Would your discussion there apply to that? In other words, what would you think should be the IMF's position with regard to the remaining 24 percent who did not participate in the decision that was made previously?

Mr. QUARLES. Well, I think that, as you noted, the official sector's interest is ensuring that Argentina has somehow resolved its situation with all of its creditors, though it needs some strategy for

dealing with the remaining 24 percent. But I do not think that it is up to the IMF to dictate that strategy; rather, the Fund says we need to ensure that you have resolved the situation with your creditors; you have done a debt exchange that has resolved that situation for 76 percent; there is another 24 percent that remains out there; you need to address that situation. But it is not for the Fund to say how that situation should be addressed. These are issues that can be worked out between sovereigns and their private creditors. And I think the system will work better if they are left to that solution, and as the system adjusts to the fact that the IMF hanging out its shingle does not get all of the debt restructuring business, if you will, the system will operate better.

I think the fact that the debt exchange has been able to proceed as it has and that Argentina has begun indicating it will develop a strategy for the remaining creditors from some public statements that have been made indicates that, contrary to the views of some it would not be feasible for restructuring to proceed with the IMF taking this stance—we create the framework, but you do the deal—contrary to that perception, it is, in fact, moving forward.

Senator CRAPO. Then in the case of future sovereign defaults, would I be correct in assuming that it would be Treasury's intention to encourage the IMF to allow countries to negotiate outcomes without IMF interference?

Mr. QUARLES. Again, it depends on how one defines IMF interference. I think that it is up to the IMF to say the debt restructuring needs to proceed. It is up to the IMF to create macroeconomic stability in the country, to engage with the country to create a macroeconomic framework in which the debt restructuring would proceed, but not to be interventionist in the details of that restructuring. Those are negotiations for countries and their private creditors.

Senator CRAPO. So it would be a stimulus for the restructuring, but not to dictate details.

Mr. QUARLES. Exactly.

Senator CRAPO. Now, Argentina has already given signals that it plans to return to the international bond market in just—I think it is 3 years after the default, the biggest default in the history. Will this send a signal to other countries to follow Argentina's example and basically default and then renegotiate their debt?

Mr. QUARLES. I do not think so. The costs that Argentina has paid for the default were substantial. There were social costs that included riots in which many people died as a result of the disruption that was associated with the default. They had to freeze the deposits in their banking system. I think anyone who looks at the consequences of Argentina's default would say that is not a model to emulate. I do not think is going to be an attractive model to emulate. And certainly in our discussions with countries in the region, we have not gotten indications that there is any sort of groundswell of view that Argentina's path is a model to emulate.

Senator CRAPO. Thank you. I think one of the lessons that we have learned from Argentina is that if the International Monetary Fund provides funding, governments tend to postpone tough decisions, and then ultimately the problem gets bigger.

When the IMF does not intervene and provide the additional funding, do you think that that provides an incentive for these countries to negotiate and resolve issues?

Mr. QUARLES. I do. There are situations in which I think IMF intervention can be helpful, but it needs to be focused on achieving objectives that are clear and in the service of a strategy that is well thought out. But, you know, as a general matter, I do think that we need to be very careful about IMF assistance, and particularly large-scale IMF assistance, as a way of forestalling the tough decisions that countries need to make.

Senator CRAPO. Thank you. I just have one more area of questioning, and I would like to shift gears now to China and its exchange rate policies and, frankly, just to ask you to share your opinion with us on the Chinese exchange rate issue and what you think the United States action, if any, should be.

Mr. QUARLES. Well, as Secretary Snow was recently before the Senate testifying, we have delivered a foreign exchange report that describes the situation with China. We have engaged with them over the course of now nearly 2 years on dealing with the obstacles to their moving to a more flexible exchange rate regime as they have defined and described them.

I think that engagement has been successful enough, fruitful enough that we have come to the conclusion that China is technically ready, as the Secretary has previously testified, to make that move. So as we consider this question going forward, we look at China in that light. So, I think we have been fairly comprehensive in the foreign exchange report that we delivered as to the details of the situation. The main point is that I think our engagement with China has been fruitful, it has resulted in progress in addressing these obstacles, obstacles on a path that they have said that they want to move on, and so I think that, as the Secretary said, they are now technically ready to move.

Senator CRAPO. Thank you. We have been joined now by Senator Bayh, the Ranking Member of the Subcommittee, who has also been very helpful not only in terms of this Committee in setting up this hearing, but also on a number of these issues. And I would like to turn next to Senator Bayh.

STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you very much, Senator, and thank you for calling these hearings. And, Mr. Quarles, thank you for your time and your service to our country.

I would like to begin by asking a couple of questions about how Argentina got into trouble in the first place. As I understand it, wasn't one of the difficulties there that they had a large systemic budget deficit problem related to the financing of the states that was assumed by the federal government? And there was some political dysfunction as well, but wasn't that one of the underlying problems that they had?

Mr. QUARLES. In my view, it was the central underlying problem, this question of fiscal federalism, which is an issue we run into in a number of countries and how to appropriately balance the fiscal obligations of a central government and a state government and a federal system. Argentina under their constitution had a system

that allowed state spending which the federal government was essentially required to fund without the ability to——

Senator BAYH. In my previous capacity, as Governor, I might have thought that was okay.

[Laughter.]

But taking a more global view, it really got them into trouble, didn't it?

Mr. QUARLES. Absolutely.

Senator BAYH. Which leads me to my second question. Given that that was part of their problem and has occasionally led other countries into difficulty as well, what ground do we stand on with our own sizable deficits, which run the risk of being systemic given the aging of our population? I mean, have we not undermined our own credibility in terms of advising other countries about fiscal probity?

Mr. QUARLES. I think the path that the Administration has outlined of shrinking the deficit in half over the course of the next 5 years is, in fact, exactly the right path to establish the credibility that we need. We need to perform on that path, without question, but given where we are currently, our debt to GDP——

Senator BAYH. Could I ask you something, Mr. Quarles? Forgive me for interrupting.

Mr. QUARLES. Not at all.

Senator BAYH. Do you encounter anyone from abroad who finds that projection to be credible?

Mr. QUARLES. I do. I guess I would say they want to see continued performance, but over the course of the last 2 years, the deficit has begun to shrink. It has begun to shrink as an absolute amount.

Senator BAYH. Are we including the costs of the military situation in Iraq and all the other things that are off budget but really contribute to our actual deficit?

Mr. QUARLES. Even over the course of the last 2 years, that has begun to shrink even factoring those in. They factor into both years. The total amount is shrinking as a percentage of GDP, and a significant element of that certainly during the last year has been an increase in revenues. So everything that observers are looking at to see in the performance of the United States in shrinking its deficit is the deficit actually shrinking, not just as a percentage of GDP, although that is certainly quite important.

Senator BAYH. Has the IMF not chastised us for our deficit and said that there is a relatively narrow and potentially closing window of opportunity to deal with it before the baby boomers start retiring?

Mr. QUARLES. I am not sure I would characterize it as "chastising," but the IMF has certainly looked at the budget deficit issue.

I think all observers agree that the key question is: Can we keep the deficit under control? Can we shrink it? Not do we need to close it immediately, because the consequences for growth of the country of closing it immediately and, therefore, for world economic growth would be substantial.

So what we need to do is establish a credible path to shrinking the deficit as opposed to closing it immediately, and so far we have been performing.

Senator BAYH. I certainly agree with the aspiration. I have only been in this town for 6½ years, but it strikes me as perhaps the triumph of hope over experience, but we shall see.

Our 6-percent GDP current account imbalance, are there other countries that are running a current account imbalance of that magnitude?

Mr. QUARLES. At the moment there is certainly no large economy that is running a current account deficit of that magnitude. Australia has for many years run a current account deficit of roughly that size, not quite 6 percent, but 4 or 5 percent of GDP.

Senator BAYH. If this occurred in another country, would we refer to it as a sign of strength?

Mr. QUARLES. It depends. I think we actually can view it as a sign of strength in Australia. There are large differences between the United States and Australia as economies. I think a significant portion of the explanation of the U.S. current account deficit is, if it results from a perception of capital around the world that an economy is a superior place for investment, then as a sign of strength of the economy, it probably is one. Is there an imbalance building up that can continue forever? It probably cannot continue forever. I think Chairman Greenspan, among others, has said that. But is it an immediate problem? Under those circumstances probably not.

Senator BAYH. My concern, Mr. Quarles, is that the only thing I can predict with some assurance about the future is that the unexpected will happen. Might there be some contagion from abroad? Might there be an energy disruption? And we can go down the list of potential horribles? Who knows? God forbid, none of them will happen. But if you look back over the course of history, something unexpected and perhaps adverse is almost always occurring. And with an imbalance of this size, have we not taken much of the slack out of the system and really run a greater risk than would otherwise be the case of having a real retrenchment in our currency with perhaps dramatic consequences for our economy?

Mr. QUARLES. When we look at the size of the deficit the first place to begin is what base do we begin from; that is to say, the current account deficit measures the growth in foreign claims on the United States, so what base do we begin from? And foreign claims in the United States, net foreign claims, are about 25 percent of our GDP, which is not at all a concerning level of foreign claims.

So they are growing, and while that cannot continue forever, when you begin from a base of that size, again, I think you say this is not a rubber band that is at the point of snapping. It is being stretched. If it comes back into adjustment, not in a disruptive fashion but in an orderly fashion, then that is something that is to be expected and something that is not likely to cause disruption to the economy.

Senator BAYH. Economic theory would suggest that it would get back into alignment through what, a continuing depreciation in our currency?

Mr. QUARLES. There are a variety of ways it could come back into alignment, and one way would be an increase in the savings rate in the United States, if you view it as the savings-investment im-

balance. Another way would be an increase in growth outside of the United States in our peer economies, particularly Europe and Japan.

Senator BAYH. Are you counting on an accelerating growth in Europe?

Mr. QUARLES. We are working with them to try to improve their prospects.

Senator BAYH. I understand, but, I mean, it looks like a difficult challenge at the moment.

Mr. QUARLES. I would agree with that.

Senator BAYH. And the reason I ask, it gets back to Senator Crapo's question, with our largest imbalance currently with China and another chunk of it with Japan, both of which really take steps to prevent the currencies from realigning, it further exacerbates the imbalance in other ways.

Mr. QUARLES. And that is one of the reasons why we have emphasized the concept of a three-legged stool as the way of dealing with the current account problem. We have the savings issues in the United States, which we can deal with by measures to increase private savings, by decreasing public dissavings by bringing the budget deficit down. You have growth in Europe as another leg of the stool, as a way of increasing the attractiveness of Europe as a locus for investment. And then you have Asian currency flexibility as a way of providing other mechanisms for adjustment.

Senator BAYH. Well, that is why I started off with our own budget deficit. It seems to me that is the one thing that we have the greatest control over. We would like to promote savings in the long-run, but that is a longer-term challenge. Growth in Europe is a longer-term challenge. Currency flexibility on the part of the Asian countries is something that should be done right away, but I suspect will take a little time to accomplish. And that is why, if we are looking at trying to put a little more flexibility into our own system to empower us to deal with the unknown, that is one thing we can do in the shorter-term.

Mr. QUARLES. We do. We need to be mindful of what the effects on growth would be, of shrinking it immediately. I think we also need to be humble about our ability to know what the effect on the current account deficit would be of a shrinkage of the fiscal deficit by any particular size. The Federal Reserve has estimates that shrinking our current fiscal deficit completely would only shave off about 1 percentage point of the current account deficit, so at a 6-percent deficit that still leaves 5 percent that needs to come from elsewhere.

Senator BAYH. It is better than nothing.

Mr. QUARLES. It is better than nothing. But given, again, when you take all the pieces of the puzzle and put them together, what would the effect on growth be? What is the likely effect on the current account deficit? How much of a current risk as opposed to longer-term risk is the current account deficit? I think the path that we are on is the responsible one of shrinking that deficit over time, developing credibility by performing on a predetermined plan, which we have identified and so far for 2 years have been, in fact, overperforming on. We are going to overperform this year. You

know, I think that is the responsible path, and so far we have been able to stay to that path.

Senator BAYH. May I have time for two last questions, Senator?

Senator CRAPO. Yes, as a matter of fact, I do not have any further questions, and so please go ahead.

Senator BAYH. I just have two more, Mr. Quarles, and then we will set you free.

For a country trying to come to grips with a budget deficit—Argentina before, some others—would the IMF ordinarily recommend tax cuts as a part of a program to try to come to grips with a deficit that a country is seeking to shrink?

Mr. QUARLES. Well, that depends on the situation. The IMF certainly will frequently recommend to countries as a way of improving their growth performance that they reduce marginal rates and broaden the base.

Senator BAYH. I am not talking about that. I am talking about net receipts. You are talking about a revenue-neutral readjustment.

Mr. QUARLES. Right, simply as a way of closing a budget deficit, if you took other things totally equal, then, no, you are not going to close a budget deficit by reducing receipts.

Senator BAYH. Thank you for your candor.

And, finally, there was a book written sometime ago by a professor from Yale—I think his name was Paul Kennedy—called "The Rise and Fall of Great Powers." And the central theme running through the book was that when great countries have security commitments and military commitments that exceed their financial and economic ability to finance, if you look back across history they have come to some heartache in those circumstances.

That is one of the reasons I am concerned that we are borrowing so much from abroad, even as our military and security commitments are expanding. Does this concern you?

Mr. QUARLES. Given the current situation where, as I said, the net foreign claims on the United States are at a reasonably moderate level for a country of our wealth and size, I do not think that we are at all at a point of crisis with respect to the growth on foreign claims or our borrowing from abroad. We do need to increase domestic savings in this country, and we need to be creative in finding ways to create the framework in which those savings will increase. But we are certainly not at all at a point of crisis as far as the growth of foreign claims on the United States.

Senator BAYH. If the Chinese were to announce tomorrow they were going to start diversifying out of dollar-denominated assets, what would happen to the value of our currency?

Mr. QUARLES. Well, I think that is hard to say. Rebalancing the portfolio——

Senator BAYH. Would it go up? Would the dollar strengthen?

Mr. QUARLES. I am actually not trying to be coy about this at all. I do not think that we can say what the——

Senator BAYH. When the rumor was going through Seoul a couple of months ago that they were going to diversify out of dollar-denominated assets, the dollar went into a fall. And when the Prime Minister of Japan, apparently inadvertently, mentioned that perhaps they would start diversifying, the dollar went into a free

fall. It is reasonable to assume that since we, in fact, borrow more from China, the effect would be the same, only more.

Mr. QUARLES. Those were very short term. I mean, what the effect would be on any particular day I think, again, is hard to say, although markets do not like new news, and so there would be some movements. Those statements were immediately retracted.

Senator BAYH. They were comments or rumors that were then denied. I am asking what if another government—in this case China—announced as its policy in fact that they were going to be diversifying out of dollar-denominated assets.

Mr. QUARLES. I do not think that the long-term effect, even the medium-term effect on the U.S. economy would be dramatic at all. What the near-term financial effects would be I think are difficult to predict.

Senator BAYH. I will let you go. The reason I ask the question is I think most people would assume that it would have a downward effect on the dollar, perhaps dramatically so, for at least a period of time. And I wonder whether that is a position of strength, of independence, and whether, in fact, in some ways our financial sovereignty is not impaired when we are as dependent as we currently are on other countries to pay our bills, including the bills of our military.

Mr. QUARLES. We have actually had a demonstration effect on that. People have been concerned about this. It is certainly an issue we have looked at in the Treasury for some time as the Asian official sector has been purchasing Treasury securities, and this concern has been articulated that we are therefore somehow beholden to the Asian official sector.

This was particularly said about Japan 2 years ago, and then about a year ago—and that if at any time Japan were to stop purchasing Treasury securities, that the effect on U.S. interest rates would be significant.

Our stance at the Treasury based on our knowledge of the Treasury market was that the likely effect on interest rates would be quite small, if anything, because of the depth and liquidity of the Treasury market, and that if even a large participant were to withdraw, others, probably from the private sector, would step in and take up those securities at a relatively small increase in cost. What we saw when Japan ceased intervening and, therefore, largely withdrew from the Treasury market in March 2004, was that over the course of the next several months, long-term interest rates, our 10-year interest rates, actually declined in line with what our hypothesis would have been before. Even the departure of what at that time was the most significant single purchaser of our securities, the complete departure from the market was largely taken up by additional private sector purchases.

So, again, we are not Pollyanna-ish about this at all. It is an issue that we look at. The holders of our debt is an issue that we continue to look at. What the possible implications rebalancing our portfolios are is something that we give a lot of thought to. But I do think that we have had this recent demonstration effect, that even the withdrawal of the very large purchaser has effects on our cost of funding, on the Treasury's cost of funding that are small, if even measurable.

Senator BAYH. Well, perhaps you are right. Let us hope you are right. It is a question of whether it is a risk we want to run. And you are a good man, Mr. Quarles. I look forward to working with you, and I am grateful for your willingness to expose yourself to our questions today. Thank you.

Mr. QUARLES. Thank you, sir.

Senator CRAPO. Thank you very much, Mr. Quarles. We appreciate your attendance.

Senator CRAPO. We will excuse this panel and call up our second panel which consists, as I indicated, of Dr. Allan H. Meltzer, who is Professor of Political Economy at Carnegie Mellon University, and Dr. Fred Bergsten, who is the Director of the Institute for International Economics.

Gentlemen, we appreciate you being with us. We have allocated, as I indicated at the outset, 10 minutes to each of you if you choose to use all 10 minutes of it for your presentation, and then we will engage in some questions, and we will start with Dr. Meltzer.

STATEMENT OF ALLAN H. MELTZER THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY, AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. MELTZER. Thank you, Mr. Chairman. Mr. Chairman, Senator Bayh, it is a privilege to have this opportunity to review progress on reform of the International Monetary Fund. I commend the Chairman and the Members for their continued interest in this important topic.

I am pleased to report that there has been progress on central issues. On other important issues, much is unfinished, and in some cases unstarted. From a comprehensive list of topics proposed by your staff, I have chosen to discuss progress toward the adoption of recommendations of the Meltzer Commission, but I touch on the other questions that the staff raised.

In the view of the Meltzer Commission, the IMF has two main tasks. Its most important activity is to increase the stability of financial markets, or if crises cannot be prevented, to localize problems or crises and keep them from spreading to countries or markets that would otherwise be unaffected.

A related but distinct activity is to reduce market risk by improving the quality and increasing the quantity of information available to lenders and creditors. The IMF has made a sustained effort to improve the quantity and quality of information on member countries. More is desirable. Especially needed are reductions in the time before information becomes generally available.

A remarkable change came to fruition this year. Argentina settled its defaulted debt with about 75 percent of its bondholders. This was the largest default ever, and it involved hundreds of thousands of individual debt holders and more than 100 separate debt issues. Coordination did not at first seem promising, but it was achieved and without outside intervention.

Unlike earlier practice, the IMF was not a party to the negotiations. It did not make additional loans to Argentina to assist in the settlement and bail out the lenders. The settlement was based on

decisions between the Argentine Government and representatives of the bondholders, particularly my colleague, Adam Lerrick, who did much of the negotiation for the bondholders. I am confident that in time Argentina can settle with the remaining bondholders without IMF intervention. I consider this a big step forward because risks and returns were related. Lenders who received high interest rates on risky loans had to bear the risk when it came. This improves the functioning of markets, warns the bondholders and spares taxpayers from paying for lenders' errors of judgment.

Also Argentina's financial problems were mainly confined to Argentina. When they threatened to spread to its neighbor, Uruguay, the IMF arranged a large loan. This is in keeping with its principal function, preventing the spread of crises.

In its response to Argentina and Uruguay, the IMF followed the spirit and often the letter of the Meltzer Commission recommendations. It is not always so. The Meltzer Commission made two unanimous recommendations. The first called for writing off debt—even Fred Bergsten agreed with us on these—the first called for writing off "all claims against heavily indebted poor countries (HIPC's) that implement an effective economic and social development strategy." The second called on the IMF to limit its lending to short-term loans leaving long-term loans for poverty reduction to others. Instead, the IMF created the Poverty Reduction and Growth Facility (PRGF). The IMF has no special expertise in economic development and poverty reduction. These problems should be left to the World Bank. While I agree with those who say that the development banks are ineffective, unfocused, and should be thoroughly reorganized—I am certainly one who believes that—duplication of their work at the IMF is not the right solution. The Poverty Reduction and Growth Facility should be closed.

The IMF, the World Bank, and the G–7 countries have not agreed on programs for debt relief for several of the heavily indebted poor countries, the so-called "HIPC countries." Some agreements have been made and countries have agreed to use the resources released thereby for education and health. Great Britain is pressing for new agreements at the 2005 summit in Scotland, and indeed here in Washington today.

Part of the discussion of debt relief is misleading, highly misleading. The HIPC countries do not actually service most of their debts and have not for a long time. To prevent default the IMF and the development banks lend the country enough to make payments, increasing the countries' indebtedness. A HIPC country receives credit for payment, but little or no new money. Debt relief, as usually discussed, is actually a way of increasing HIPC country borrowing. It would increase the countries' available resources, since debtors would receive the same payment but would not have it offset by a debt service payment of similar size to the international financial institutions. The net transfer would increase.

The main issue in current discussion are how the transfer should be financed and how the increased net transfer should be used to improve social and economic conditions in the debtor countries. Gold sales by the IMF are one option that has been proposed. As you know, the Congress wisely disallowed the sale of the U.S. gold deposit at the IMF without its consent. The gold should be re-

turned to the members and revalued by them. Part of the profit could be used to reduce HIPC debt. Gold sales would have to come before this Commission. I hope it would be turned down.

One of the Meltzer Commission's main recommendations called for replacement of conditional loans with loans based on a limited number of preconditions accepted in advance by the troubled country. The purpose of this proposal includes reducing risk, increasing incentives for reform, and giving the borrowing country a large part of a choice of its own policies. To its credit, the IMF has reduced substantially the number of conditions attached to its loans. It considered but did not adopt preconditions. As part of the comprehensive review of this strategy that is now under way, it proposes that future lending should be "anchored in strong country ownership."

Now, I should say that the IMF is in the process of examining its procedures and it will issue a final report on what needs to be done at its September IMF/Bank Fund meeting here.

This is a good step away from the command and control of the 1990's based on the so-called "Washington consensus." "Ownership" means that the country has a major role in the choice of policies. Much evidence suggests that reform is made more likely when political leaders in the country choose it, support it, and decide to implement it. The Fund's own research suggests that much of the time countries do not implement the conditions to which they agreed to get a loan.

Preconditions reduce risk in other ways. Countries that avoid pegged but adjustable exchange rates, improvident fiscal and inflationary monetary policies, and weak financial systems are more prone to crisis. Reducing or removing these sources of instability reduces the chance of a crisis. Further, negotiated preconditions accepted in exchange for a commitment to assist in a crisis reduce the long delay that often occurs before assistance is given.

A critical part of this proposal is that countries would have greatly increased incentives to reform. If they did not agree to preconditions, they would not be eligible for assistance. This alone increases the incentives for reform. But this incentive increases because private sector lenders would distinguish between countries that adopted reforms and those that did not. They do not under the present long-time prevailing arrangements have much incentive to do that.

The international private capital market is the principal supplier of loans. It offers 5 to 10 times the volume offered by international financial institutions. The private market would offer more loans at lower interest rates to countries that adopt preconditions. They are safer. Reformers in the countries could replace arguments claiming that the IMF requires reform with citation of the benefits to the country, more capital at lower interest rates.

The IMF faces many possible challenges. Will other countries follow Argentina by defaulting and renegotiating debt, as your question asked a few moments ago? Will recognition of increased risk reduce the amount of private sector lending? Does the large accumulation of reserves by Asian countries and other recent changes signal a decision by these countries to manage future crises without the IMF? Have the Asian crisis countries taken a further step

toward development of a regional financial bloc? If the IMF no longer bails out private lenders, will private lenders object to the IMF's preferred creditor status which has no legal basis?

The IMF's loans are heavily concentrated in the debts of a small number of countries. Will one or more of these countries default on the IMF?

We should recall that the IMF's original purposes included monitoring and maintaining a fixed exchange rate system. The IMF should take more responsibility for the exchange rate system to adjust under or overvalued exchange rates. It is well know that if more countries allowed their exchange rates to adjust, there would be fewer crises. Many observers claim that undervalued Asian exchange rates and the large U.S. current account deficit will end with a major financial crisis. They use the word "unsustainable" when they discuss the U.S. current account deficit. I am far from certain, even skeptical, about these claims. But we should recognize that there is a risk that will not be removed and may be increased by the many adjustments that follow an appreciation of China's exchange rate. In keeping with its original purpose, the IMF should try to implement a cooperative solution that revalues the yuan and reduces the U.S. deficit, current account deficit.

Finally, corruption is a major problem in some developing and developed countries. No one can rid the world of bribery and corruption, but the IMF could do more than it now does to limit it.

Thank you.

Senator CRAPO. Thank you very much, Dr. Meltzer.

Dr. Bergsten.

STATEMENT OF C. FRED BERGSTEN
DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. I am delighted to be before the Committee again, particularly because Dr. Meltzer and I completely agree on the one issue I want to emphasize. It is the last issue he mentioned, which has to do with the adjustment of the huge international imbalances we now face and which Senator Bayh has already emphasized.

I want to make just one point to the Committee, and it echoes what Dr. Meltzer said at the end but puts it more strongly. The International Monetary Fund (IMF) is failing to implement its own rules on one of the most crucial issues facing the world economy—the imbalance in currency relationships. This imbalance in turn is a central problem in the current account difficulties that we face, and that surplus countries face, and that raise the crisis risks for both the world economy and our own domestic trade policy. You here in Congress see these risks every day when you confront pressures to restrict trade, in large part because of the big currency imbalances and their pass through to our big current account deficit, of which the main counterpart is the surplus countries.

I want to focus on why the IMF should be doing more in this area and why the U.S. Government itself should be mobilizing the IMF much more effectively, enabling and indeed pushing the IMF to be much more effective at exercising its stewardship responsibility for the world economy.

As Senator Bayh has mentioned, the global current account deficit of the United States is very large. Indeed, it is now getting

close to an annual rate of $800 billion or 7 percent of our GDP, and it has been growing by over half a percent of GDP a year for 10 years. In short, it is on an unsustainable trajectory. Not only is the level bad, but also its trajectory and future growth.

On the flip side, the global current account surplus of China is also very large. China's global surplus this year will exceed $100 billion, more than 6 percent of its own GDP, and it too is growing very rapidly. But it is not just China. A number of other Asian countries have very large and growing surpluses, most notably Japan, which still has by far the largest surplus of any country in the world, but also Korea, Taiwan, Hong Kong, Singapore, and Malaysia, all running substantial global surpluses, which are the counterpart of the U.S. global deficit. And it takes two to tango—you cannot get our deficit down unless you get the surpluses of the surplus countries down.

As Senator Bayh said, the United States has to lead the correction of the imbalances by increasing its rate of national saving. Incidentally, we have to borrow $5 billion of foreign capital every working day to keep our own economy afloat. If it does not come in happily at current interest rates, exchange rates, equity prices, property prices, and the like, we will face financial instability, whether a crisis or not. It is a vulnerability we want to avoid. So we have to take the lead. But an essential part of the correction inevitably is a further large decline in the exchange rate of the dollar, which I would estimate at being something like an additional 20 percent or so on a trade-weighted average against the currencies of our major trading partners.

Over the last couple of years, the dollar has already declined a lot against the truly floating currencies—the euro, the pound, the Swiss franc, the Canadian dollar, and the Australian dollar. But the next phase of the dollar decline needs to take place against the currencies of East Asia because those countries are running the world's largest surpluses, they have the world's fastest growth rates, and they have been intervening massively in the currency markets to block appreciation of their currencies—in the cases of China and Malaysia—or to limit the appreciation far below what market forces would have produced.

It puzzles me that our own Administration and the rest of the G–7 governments, all of whom profess fealty to market economics and letting the market determine these things, have been very slow in responding to this blatant, sizable, and prolonged intervention, which clearly blocks market forces. China is the key. Some people do not even realize that China, by pegging to the dollar, has actually ridden the dollar down over the last 3 years, meaning that the Chinese exchange rate has not just stayed flat against the world but has actually weakened, meaning that the most competitive country in the world has become even more competitive by riding the dollar down against the euro, the Canadian dollar, and even to some extent the yen and other currencies in Asia.

Moreover—and this is really crucial—the other Asian countries, from Japan all the way through India, are very reluctant to let their exchange rates rise against their tough competitor China and therefore are unwilling to let their rates go up against the dollar,

if that also means going up against the renminbi, as it does, as long as China continues to peg to us. It is a big problem.

What should be done about it? In my view, it is the responsibility of the IMF to promote correction of such huge costly and potentially destabilizing imbalances in the world economy. In fact, the Fund's own Articles of Agreement enjoin member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other member countries."

Back when floating rates became the norm of the system in the 1970's, the Fund fleshed out that rule and laid out principles to monitor exchange rate practices. Its principles identified three variables as determining whether a country was manipulating: Protracted large-scale intervention in one direction in the exchange markets. China clearly meets those criteria. Incidentally, up to a year ago, so would have Japan, but it has not intervened for the last year. Malaysia also meets the criteria.

To its great credit, Secretary Quarles and our own Treasury indicated this in its latest semiannual report to the Congress, after it had whitewashed China's behavior for a couple of years, but still inexplicably fails to label China a manipulator *per se.* It nevertheless strongly attacks the Chinese exchange rate practices and calls for immediate action. Whatever the language of the Treasury reports, the United States and the rest of the G–7 should insist that the IMF insist that China and a few others comply with its own rules, which I just reiterated.

Several people, myself included, have talked about the possible need for trade remedies to induce China to move its exchange rate in a constructive direction. That may at some point be necessary. But first we should certainly try the multilateral, institutional, legal approach readily available to us in the IMF. It amazes me why the United States and the rest of the G–7 have not gone that route. If you had to bring a trade case later in the World Trade Organization (WTO), you would then have the requisite IMF underpinning for it, which is required under WTO rules anyway. So it is a win-win proposition, and we have to do it.

The Fund has limited its own activities in this area to quiet efforts to persuade China to become more flexible in its currency regime, which is certainly desirable over time, has not focused on the immediate need to raise the value of the exchange rate of the renminbi. Secretary Quarles and the Treasury talked rightly about the need to flexibilize the Chinese economy, its banking system, and its monetary policy, so that over time it can move to a more flexible exchange rate. And the Chinese themselves have said that.

But you do not need any of that to get what I think is necessary, namely, a one-shot revaluation of the exchange rate of the renminbi. They should keep the fixed exchange rate for now, though widening the margins to make it more flexible. They should keep the capital controls for now, given the weakness of the banking system. But they should substantially change the price of their fixed rate.

Our analysis shows that if China would revalue its currency by 25 percent, and the rest of the Asians would go halfway in that di-

rection, it would reduce the U.S. current account deficit by at least $60 billion. If the rest of the Asians went all the way with China, which the markets might well push them to do—and they might then be prepared to do—the United States would achieve something like $100 billion of current account correction.

As I said before, we are running an $800 billion deficit now. We need to cut it by $300 billion to $400 billion—not to zero but roughly in half—and this achievement from the correction of the Asian currency relationships would carry us a substantial way down the path. We still have to increase our own saving rate and the Europeans still have to grow faster but we would get at least a quarter to a third of the needed correction if we got the adjustment of the Asian currencies.

So the bottom line—and I want to emphasize that one point today because I think it is so crucial and so urgent—is that our own government and the rest of the G–7 should insist that the IMF take the lead and implement its own rules. It does at the end of the day come back to the United States and the G–7.

The G–7 finance ministers are meeting this weekend. I hope they agree to launch this initiative. The G–8 summit is meeting in a month. Tony Blair is here talking with President Bush about it today. It is well and good for the G–8 to take new steps to help Africa develop and to worry about climate change but we have a critical, large, and urgent problem facing the world economy. I hope and recommend that the G–7 countries, at the finance ministers' meeting this weekend and at the summit next month, mobilize the IMF to implement its own rules to get this crucial part of the global adjustment under way.

Thank you.

Senator CRAPO. Thank you very much, Dr. Bergsten.

I will start out with you, Dr. Meltzer. You indicated in your testimony—in fact, let me go back to a previous hearing about 3 or 4 years ago, when we were talking about the Meltzer Commission's report and the World Bank. And this is going to tie in to my first question. I am recalling at that time that one of the reforms that was proposed for the World Bank was that instead of just making loans to national that were basically over which we did not have any real oversight, that we instead—and I am not remembering the exact mechanism—but that instead that we focus on the exact services that were intended to be provided and pay for the services, rather than simply making an unmanageable loan. Could you clarify that a little bit for me?

Mr. MELTZER. Yes. What we wanted and what we recommended was managed grants.

Senator CRAPO. That is right.

Mr. MELTZER. To its credit, the Bush Administration has pushed that. It has met a lot of resistance from some of those people who are out there today saying, "We need to give $50 billion more." They resisted the idea of giving monitored grants, but they eventually made a small step in that direction. We need to take a much larger step.

What we would do is we would say, "Pick a problem. Let the country pick its problem." It says, "We want water, potable water

in the villages. We will hire somebody, take bids, get potable water in the villages, and pay them when it is there."

Senator CRAPO. We pay the provider of the service?

Mr. MELTZER. The World Bank, yes, pays provided the water is there. That way we get around some of the corruption that is involved, some of the non-feasance perhaps.

Senator CRAPO. Is the World Bank operating that way to any significant extent?

Mr. MELTZER. To a very limited extent. The World Bank fought the idea, the French particularly did a lot of talking right after the report came out. The French said, maybe we will do this by 5 percent or something, of the amount that we give; a trivial amount and only as a sop to the United States.

Senator CRAPO. The reason I ask is that, as you know, the Meltzer Commission unanimously recommended that the IMF should get out of the business of poverty reduction loans.

Mr. MELTZER. Right, and I still recommend that.

Senator CRAPO. I think you still recommend that, and if I understand your testimony correctly, you recommend that the Poverty Reduction Growth Facility simply be eliminated. Dr. Bergsten I think recommends it be transferred to the World Bank.

Mr. MELTZER. That is essentially the same thing.

Senator CRAPO. And that is about the same thing. So the World Bank is doing that function, and the question I was getting at is do you both agree that it should not be a function that is performed by the IMF. First of all, do you both agree with that?

Mr. MELTZER. Yes. I think the main reason is that it does not believe that the World Bank is an efficient mechanism for doing what it is supposed to be doing.

Senator CRAPO. Dr. Bergsten.

Mr. BERGSTEN. I certainly continue to agree with that view. I would add that there have been a couple of management changes at the IMF since the issuance of the Meltzer report, and under one of those moving the Poverty Reduction and Growth Facility to the World Bank was seriously considered. The management, in fact, was convinced that it was the right thing to do.

When the management toured Africa and talked to the beneficiary countries however, they all very strongly resisted the idea. It was not just the French on the donor side. It was the recipient African countries who argued that the only benefit they could get from IMF membership was the credit from this Poverty Reduction and Growth Facility.

Moreover, when faced with the alternative of shifting it to the World Bank, the African countries said, "Ah, but that is not really quite the same thing. The IMF is a much more serious institution; and if we pass muster with the IMF, we get a lot better rating in the credit markets." Both Dr. Meltzer and I would like to see them move toward that.

It was very interesting how that issue evolved. Implementing the transfer, not elimination, but the transfer from the Fund to the Bank was seriously considered. In fact, in their usual bureaucratic way, they had even cooked up a swap, where the Fund would transfer the PRGF to the Bank and get something back in return so they would not have to fire too many of their bureaucrats.

Senator CRAPO. But you still support that transfer.

Mr. BERGSTEN. I support the transfer. It needs to be done. It is way overdue.

Senator CRAPO. All right. Dr. Meltzer, in your testimony, again, you also talked about the preconditions to assistance that we need to assure are in place. Could you specify a little more detail about what those preconditions should be?

Mr. MELTZER. Yes. They would be fiscal solvency, proper monetary policy, an adjustable exchange rate, opening the banking system, the local banking system to foreign banks, which, incidentally, is an agreement that we have, that countries have with the World Trade Organization, so it is something that just says they ought to do what they have agreed to do and slowly they have been doing it. Those would be some of the principal things we would do. We would avoid some risks with foreign banks in the country. When there is a banking problem they would run to the foreign banks instead of run from the currency, which is a much better solution, and with a more flexible exchange rate they would be less prone to crises. The biggest problems that we have had in recent years have been combinations of banking crises and exchange rate crises. The preconditions would try to get rid of those, but would recognize that there are other sources of crisis and, therefore, we would lend to them automatically when they came through. Automatically means that the IMF would continue to monitor them and would keep them on the preferred list, if you want, and that would be a market indicator to people in the private market which says, hey, this is a good country or this is not a good country.

Senator CRAPO. And would you agree that that is probably the most significant reform that we should focus on at the IMF at this point?

Mr. MELTZER. Yes. That is hard to get. I mean, they have thought about it. They actually announced something which is very close to that called CCL. You know, they could not get very many countries to agree to it. One reason that countries would not agree to it was the IMF would not make the guarantee that the country would get the assistance.

Senator CRAPO. So why make the reform if I do not get the assistance.

Mr. MELTZER. Exactly. Why make the commitment?

Senator CRAPO. Dr. Bergsten, I want to get to your points on China, but, first of all, your thoughts on the suggestions about the preconditions to assistance and that being the next strong focus.

Mr. BERGSTEN. I am very pleased that Dr. Meltzer's views on the nature of the preconditions—it is fair to say—have evolved a bit over the years, because when the Commission report was prepared and issued—it is fair to say—he will have to correct me as the chief author.

Mr. MELTZER. I will.

[Laughter.]

Mr. BERGSTEN. I am sure.

Senator CRAPO. It would not be a hearing between you two if we did not have a little bit.

Mr. BERGSTEN. As I recall, the overwhelming emphasis in terms of preconditions from the majority was the soundness of the banking system in a developing country.

Mr. MELTZER. Not true.

Mr. BERGSTEN. Well, let us go back and parse the language. That is an eminently desirable requirement, but it is not enough. The point that the minority emphasized in our dissent was that limiting the preconditions in that way might have two very adverse effects. One, it might enable a country to get IMF credit even if its macroeconomic policy was way out of whack; and, two, it might preclude assistance to a country which needed the help and was systemically important but had had a weak banking system.

Let me illustrate by referring to the country you discussed earlier—Argentina. My recollection—and I am basing this largely on a study done at my institute by Michael Mussa, the former Chief Economist of the IMF—is that the Meltzer Commission majority's criteria would clearly have qualified Argentina for IMF credits deep into its crisis period because, prior to the crisis, Argentina had a sound financial system with lots of foreign banks. Indeed, Charles Calomiris, one of the chief architects of the majority report, said so publicly.

So if one of our goals—and I address that in my written statement—is to avoid big IMF mistakes like the big credits to Argentina, which prolonged the crisis and expanded the agony, the Meltzer majority's remedy would not have done that. So the broadening of Professor Meltzer's criteria to now focus first on fiscal policy, second on exchange rates, and third on the banking system sounds a lot better. But it is not complete. There is monetary policy, as he well knows. There are lots of other things. I think any set of preconditions is going to be limiting, but I like Meltzer 2005 a lot better than Meltzer 2000.

Senator CRAPO. Well, I am going to let Dr. Meltzer have the last word on my testimony here, and then in the second round I will come back to you, Dr. Bergsten, on your issues regarding China.

Dr. Meltzer, you can have the rest of my round.

Mr. MELTZER. Rather than argue about the past, which is written down in print and I know what is there, let me just say that I am very happy that we agree now, at least we seem to agree now that preconditions would be a very good way for the Fund to go. That is the important point going forward, not arguing about the past.

Mr. BERGSTEN. I did not say that I would go for preconditions. In fact, my last comment was that any set of preconditions is almost certain to be too constraining.

Senator CRAPO. Dr. Bergsten, you do not agree with preconditions?

Mr. BERGSTEN. No, and I think the experiment that Professor Meltzer mentioned with the contingency credit line, the CCL, is evidence of the problem. There were no takers.

Senator CRAPO. Okay. Anything else, Dr. Meltzer?

Mr. MELTZER. There were no takers because I sat in a meeting with the Managing Director of the Fund—and there were four or five of us there—it was pretty clear that the Fund bureaucracy would not agree to making a contingent credit line, CCL, would not

agree to do that and say if you meet the conditions you get the assistance. What they said is, well, we want to take another look-see, we want to see whether everything is okay. That is what stretches out the problem. And Mexico was a good example where we stretched out the problem for months. Things got worse and worse and worse, and eventually we faced a big crisis. It would have been a crisis but a smaller crisis if we had handled it early along the lines that we suggested, that I suggested.

How much earlier? Well, that crisis was clear and apparent as early as July of the year before they devalued. That is when the United States started to give 700—what the United States used to do was almost—was just terrible. They would lend them the money on Friday so that it would show up on the statement of the Mexicans on Monday, and then on Tuesday the Mexicans would pay it back.

Senator CRAPO. Let me interrupt because Senator Bayh is under a time pressure. I want to give him some time for questions here.

Senator BAYH. Thank you. I apologize. It is a fact of life around here that sometimes you are required to be in two places simultaneously. I have yet to figure out how to accomplish that without feeling like I am shortchanging both sides of the equation.

I want to thank both of you. Just real quickly, Dr. Meltzer, it sounds as if you feel that the outcome in Argentina has occurred in a way that will limit the risk of moral hazard going forward.

Mr. MELTZER. Correct.

Senator BAYH. One of the last meetings we had of this Subcommittee, we had a roomful of the creditors, and I do take some exception to the actions of the Argentine Government. But at the same time, we looked at the creditors and said, you know, they call it a risk premium because it is risky?

Mr. MELTZER. Right. And they will learn that much better if they go through the Argentine—where they lost a very large amount.

Senator BAYH. And I do not want to put myself in the middle of your conversation here, but in your view—the Argentines defaulted for 24 hours and then made their payment to the IMF. Was that correct? They technically defaulted?

Mr. MELTZER. No. They defaulted on their debt in December——

Senator BAYH. I am talking about to the IMF.

Mr. MELTZER. The IMF, oh, yes, but that was just—that was nothing.

Senator BAYH. In your remarks, in your testimony, you posited the risk of other defaults going forward and that kind of thing.

Mr. MELTZER. Right. As Secretary Quarles said—and I asked this question of the Brazilians, especially the Brazilian Finance Minister, how would they feel about defaulting on their debt as a result of Argentina? They said the Argentina experience was rather bad, so that has quieted the people in Brazil who think we should default on the debt because it was so bad. And that is encouraging.

Senator BAYH. Are we talking about private sector debt or IMF debt?

Mr. MELTZER. As well as government sector debt. I think the pressure in Brazil was to default on both, but especially on the public sector debt. So, I think that is encouraging.

On the other hand, it is a long time, and we have countries—we had Peru at one point, Alan Garcia defaulted on the IMF debt, and it stayed defaulted until he was thrown out. Now he is a candidate for President again and we do not know—Peru is not doing too badly.

Senator BAYH. You think the lesson that some of the other countries have taken away from this is that——

Mr. MELTZER. They got rid of 70 percent of their debt.

Senator BAYH. I was going to say that from what I can tell, just as a lay person observing from afar, they have not concluded that default led to their problems but was perhaps one step in getting out of them which is a dangerous conclusion to reach.

Mr. MELTZER. Well, but I think it was your comment before—that is right. It is a dangerous conclusion to reach. But your comment before was Argentina is going to return to the debt market. My prediction to Mr. de Rato a couple of months ago was that when they settled this, as I thought they would, the investment bankers would be on the next plane down to Argentina with a suitcase full of bonds. So why did they do that? Well, they say, you know, Argentina does not have much debt anymore; you know, 70 percent of it has been wiped out, or thereabouts.

Senator BAYH. It is collective amnesia?

Mr. MELTZER. Or the greater fool theory.

Senator BAYH. They are all evaluated on short-term performance and do not think about the long-term risks perhaps. But my final question to you, and then, Dr. Bergsten, a couple of things for you. As I understand it, Argentina has in some respects not followed the conventional economic advice from the IMF and others in trying to get their country back on the right track, and yet things seem to have stabilized, and at least temporarily there is some growth taking place there.

Now, is the lesson that they and others are going to derive from that just, you know, hey, we can flout conventional wisdom in these areas and things will turn out just fine? So my question to you would be the sort of stabilization of Argentina, return to some growth, is this a lasting phenomenon there? Or what lessons will be derived from that?

Mr. MELTZER. I do not think it is a lasting phenomenon, but it certainly has been a successful couple of years for Argentina. It is growing fast and all that. It has not gotten its GDP back to where it was before it defaulted and before it devalued.

Senator BAYH. Let me ask the question a little bit differently. If you are a country that is on the cusp of getting into some difficulty, are you going to follow the IMF's advice? Or based on Argentina's experience, are you going to follow their path? I mean, they might look at this and say, hey, things turned out okay for Argentina, maybe we should try that, too?

Mr. MELTZER. Yes, the history, first, is that countries, I think according to the IMF's own evaluation, countries follow about 50 percent of the advice that they agree to when they make these agreements. So there has not been a strong record, and there has been study after study to show, is there an effect of the IMF? Well, it is hard to see. Even the IMF study, it is hard to see that there is much effect of the advice that they give.

Senator BAYH. I am not sure Congress takes 50 percent of the advice we get. What do you think?

Mr. BERGSTEN. Bringing down the average badly.

Mr. MELTZER. In the case of Argentina, I would say Argentina, in my experience with a large number of countries, even Brazil, is one of the most nationalist countries I have ever seen. I mean, we are Argentines, we do not have to take advice from anybody. And they do not. So they did not follow too much of the advice.

Senator BAYH. I am more concerned about what other countries will think going forward, observing this experience. Will they conclude, hey, the IMF prescriptions, you do not need to follow them in order to get back on your feet and heading in the right direction?

Mr. MELTZER. One hopes not, but, I mean, I would not want to make a prediction as to what is going to happen in Latin America, especially, which is where the IMF has been most active. You have a lot of countries—Venezuela is certainly not going to take advice from anybody. Bolivia could take advice from almost anyone and do better than it is doing.

Senator BAYH. Do you have a take on all this, Dr. Bergsten?

Mr. BERGSTEN. Yes, I would be more optimistic. One of the remarkable elements of this whole episode has been the failure of the Argentine example to spread to other countries. We do not know whether it will over the long-run. But so far, so good on that count. There was a lot of fear that the Lula government, when they took office in Brazil, might have been tempted to follow the Argentine example. After all, they had problems. They had to go to the IMF. Many people thought Brazil would have faced a debt crisis. There was legitimate debate about that.

Brazil rejected the Argentine model very explicitly and went the more conventional way. But here is what I think the explanation is. One has to be very careful about the timing of when the Argentines defaulted. On my reading, the Argentines defaulted when they were already well into their crisis. They had huge and unsustainable fiscal deficits. They had a hugely overvalued exchange rate which they had maintained way too long. And, incidentally, the IMF had failed to criticize them on both counts.

A huge failure of the IMF was not using the good times—when Argentina was doing well in the mid-1990's—to lean on them on the budget and on the exchange rate system. The IMF failed to do that. The IMF is culpable for the onset of the Argentine crisis and then for prolonging it by giving them a big loan after it was too late.

But from the Argentine standpoint, the key element is that they were well into the crisis. Things were crumbling all about them. So it was not whether to default to avoid a crisis but to default to avoid an even deeper crisis, even deeper recession, which would have been required to keep paying the debt on schedule.

So in that sense, the default has been a huge success for Argentina, as their president reminds us every day. But as I tried to document in my statement, none of the feared spillover effects have been observed, at least to date, and I do not think will be, because everybody realizes that what Argentina went through is devoutly to be avoided. When the Lula government in Brazil looked at the alternative of taking preventive action to head off getting into a cri-

sis, including continuing to pay its debt, that looked a lot better than letting things deteriorate and then having an excuse to default.

So the timing element is really crucial. In that sense, the Argentine episode is probably *sui generis*, at least relative to most countries see it coming and can head something off, with or without IMF help, at an earlier stage.

Mr. MELTZER. Before you go, Senator, I would like to object or at least differ with Mr. Bergsten on one point that he made to you on a subject which is of considerable interest. He described the position of the United States and the need for reform as urgent. I do not think it is urgent. I think there is a risk. But I think it is wrong to make a crisis out of a problem. We have a problem. It has been going on.

Senator BAYH. You are referring to our current account imbalances?

Mr. MELTZER. Current account imbalance, the Chinese exchange rate, and Southeast Asian exchange rates. I think there is a problem. But the problem comes—has been there for a while and it is going to be there for a while. And it is not going to go away, and we do not need to treat it as a crisis. That is how we can make crises occur. We should recognize it as a risk.

Senator BAYH. I am tempted to ask you whether you think Social Security is a problem or in crisis, but I will not.

Mr. MELTZER. It is not a crisis. It is a problem.

Senator BAYH. My point simply is crisis/problem, it is kind of in the eye of the beholder in some senses. We are trying to deal with both short-term and long-term problems. But I appreciate your comment.

Mr. BERGSTEN. I would like to make one comment back to Dr. Meltzer, though, because he and I firmly agree on trade policy, the need to avoid trade restrictions, and maintain an open trade system.

Mr. MELTZER. Until today.

Mr. BERGSTEN. But we agree on the basics. Here is my point: The current account imbalance and the continued overvaluation of the dollar have two unsustainabilities. One is the international financial unsustainability, the risk that the foreign capital might stop flowing in, the dollar might drop sharply, up goes inflation, up go interest rates, down goes our economy. And Professor Meltzer rightly says we do not know whether, that could be sustained for a while longer, we do not know when, if ever, that risk will become a crisis.

But I would submit there is a second unsustainability, which is already pretty close to becoming a crisis—the domestic political unsustainability, the pressures you all face every day to restrict trade as a tenth-best alternative to getting the macro imbalances under control.

Senator BAYH. Let me follow-up on——

Mr. BERGSTEN. If you look at the record of U.S. trade policy over the last 30 to 40 years, the best leading indicator of U.S. imposition of trade barriers is not the unemployment rate or any of our domestic economic variables, it is the external imbalance in the valuation of the dollar. When the dollar gets way overvalued, when we

run big current account deficits, the domestic politics of trade policy shift. A lot more industries and workers look for import relief. Export interests decline in interest and clout. The domestic politics changes. That is when we risk breaking the trading system.

When Jim Baker did the Plaza Agreement in 1985 and drove the dollar down 50 percent over the next 2 years, he did it not because there was any fear that foreign investment in the dollar was collapsing. It was because the Congress, as some of my friends in the Ways and Means Committee put it at the time, would have overwhelmingly passed the Smoot-Hawley tariff had it come to the floor. It was the trade system that was at risk, and that is where I think Dr. Meltzer and I probably would agree.

Senator BAYH. If I could just conclude, I apologize I am going to have to run to this other meeting. I was intrigued by your suggestion that we go to the IMF. What suasion can the IMF bring other than just—what leverage do they have on countries?

Mr. MELTZER. They can try to arrange a bilateral movement.

Senator BAYH. To put a fine point on it, why should the Chinese listen to them if they are not listening to us?

Mr. MELTZER. The Chinese—it is useful when you think about a problem of this kind to think about what is it that is motivating the Chinese. What is motivating the Chinese is 150 million Chinese who would like better jobs. All right, so keeping their exchange rate, we should understand that. Employment is a big issue for us and always is a big issue for us.

Senator BAYH. I appreciate their domestic motivations very well.

Mr. MELTZER. All right.

Senator BAYH. If the IMF goes and begins to engage in these discussions, why would the Chinese not just dismiss them?

Mr. MELTZER. It would try to make a bilateral change or a multilateral change; that is, it would try to negotiate—instead of our spitting at the Chinese and their spitting back, we would try to get together and find something which would say we will do something and you do something and, therefore, we need an intermediary.

Senator BAYH. It gives them a multilateral cover for doing the right thing, it is a loss of face, that sort of thing?

Mr. MELTZER. On both sides.

Mr. BERGSTEN. It is a name and shame campaign to mobilize not the United States bilaterally, as Dr. Meltzer said, but the global community through an institution of which China is itself not only a member but also a very active member—it has its own seat on the Executive Board—to bring a collective judgment that what China is doing is hurting not the United States job situation but the world economy as a whole.

Senator BAYH. So it is moral suasion.

Mr. BERGSTEN. It is moral suasion. It is a name and shame campaign.

Senator BAYH. Unlike the WTO, though, there is nothing concrete they can do to actually——

Mr. BERGSTEN. I am afraid that is right. But as I said, if that did not work and we then had to go to the WTO, in a case like that the WTO rules require the imprimatur of the IMF in the first place. So you would have it, and then you could take it to the WTO and say there is nullification and impairment, there is a subsidy—

you could use at least three WTO rules. But you would have to have IMF validation.

Senator BAYH. My last question: Is there any doubt in your mind in terms of what the IMF would conclude with regard to currency practices of China?

Mr. BERGSTEN. If the IMF read its own rules literally and in terms of common English, there would be no doubt.

Senator BAYH. The reason I ask is that our own Treasury just issued a document that—well, it was curious.

Mr. BERGSTEN. I agree with that, as I said in my statement. The IMF, like any international institution, is political. I am sure the Chinese would lobby against a movement of that sort, and it would be a test for the IMF. And that is one reason I would like to pose it.

Senator BAYH. Gentlemen, thank you very much.

Senator CRAPO. Thank you very much, Senator, and we appreciate your support here.

Actually, Senator Bayh got into exactly the area that I was going to get into at the conclusion of my questioning, my last questioning period, and that is, I am intrigued, Dr. Bergsten, by your suggestion that we turn to the IMF to try to get China to take the right steps. And there has already been a discussion here about just what authority and ability the IMF might have.

I would like to pursue that a little further, and let me be sure I understand your testimony correctly. You indicate that you think that the current pressure to cause the Chinese to simply float their exchange rate is not the right suggestion——

Mr. BERGSTEN. In the short-run.

Senator CRAPO. In the short-run.

Mr. BERGSTEN. Right.

Senator CRAPO. In the long-run it would be, but that in the short-run we should just have one significant revaluation of the exchange rate of the renminbi. Did I say that right?

Mr. BERGSTEN. You got it.

Senator CRAPO. To have a revaluation, and that revaluation would be, in your opinion, best if it were around 25 percent and followed by the other Asian nations.

Is there anything that we could argue—in this discussion that the two of you have indicated could and should take place through the IMF to try to be a facilitator of this decision, is there anything other than simply saying, hey, it is best for the world that you do this?

Mr. BERGSTEN. Yes. I think—and here Dr. Meltzer is, of course, right—the Chinese are going to be driven to a very large extent by their internal considerations. One can make an overwhelmingly persuasive case that this big revaluation is very much in China's internal interest.

Senator CRAPO. I had heard some discussion to that effect, and that is why I asked the question.

Mr. BERGSTEN. There are three reasons. One, their top leadership has acknowledged the economy is growing too fast. They say they want to slow it down, at least a percentage point or two, for the next couple of years. A revaluation would do that by slowing growth of demand for their exports.

Two, they have inflation pressure. It has calmed a little bit now, if you believe the official statistics, but it is still substantial. Less than a year ago, it was running 8 to 9 percent on their inter-company producer price index. A revaluation of the currency will reduce import prices and fight inflation.

Three, huge flows of speculative capital are coming into China, despite their capital controls, and ballooning their money supply. They are adding $20 billion to $25 billion per month to their foreign exchange reserves. They buy those dollars to keep the price of the dollar up and renminbi down. That is the way they keep their fixed rate and avoid the market pressure for appreciation of their currency.

But the monetary effect is a huge increase in their international reserves which in turn tends to increase the domestic money supply and generate inflation pressure.

The People's Bank of China, like any central bank, tries to sterilize that but they themselves admit they are not able to do that fully because the capital inflow is so great. And that is, therefore, expanding the money base; that it is adding to the inflation pressure. Moreover, since that money goes through the private banks, it is likely the private banks are making bad loans, nonperforming loans to their state-owned enterprises and others, thus reversing the progress they had been making in reducing the instability of their financial system. So the IMF should be arguing with them purely on domestic grounds.

In addition, they are getting a spate of external trade barriers against their exports. We are seeing it every week here—for example, against their textile products. But it is not just textiles—it has been semiconductors, wood furniture, color TVs, and shrimp. It is widespread and growing rapidly. The Europeans are now joining in the game. So the Chinese face a real choice on the external side—taking more trade barriers against their exports or revaluing the currency.

When you add that to the internal reasons, it makes for a very powerful case, which our own Treasury and the IMF can, and should, be making. It would clearly provide an internationally defensible, persuasive case to mobilize the international community through the IMF to go to the Chinese and argue sweet reason. It might still not work, but it would be different if the world as a whole through the IMF were doing this rather than the United States bilaterally or even the rich-country grouping in the G–7.

Senator CRAPO. Dr. Meltzer, do you agree? And do you have anything to add to that?

Mr. MELTZER. I do not think there is a crisis and people have been warning about this crisis for quite a long time. I do think that there is—of course, I understand and I am sure you understand—the pressures that come on Congressmen and Senators about trade. But it is important to remember that, gee, we are pretty close to full employment in this country. We may be losing jobs, but we are also gaining jobs. It is not true that we are going to have a huge effect. I think Fred is simply way off base if he thinks the Chinese are going to revalue by anything like 25 percent. You know, I think they are talking about something much smaller than that. It is not going to have a big effect on our current account deficit. So we

ought not to run the risk of upsetting a system which has worked very well since 1950 in terms of producing more growth in more countries and more spread of freedom than any system that we have had at any time in man's history. We ought to remember that we sit at the end of a period of enormous progress all over the world, and we do not want to disrupt that system, and the open trading system is an important part of——

Senator CRAPO. And you believe the disruption would be any kind of trade retaliation.

Mr. MELTZER. I think the trade—that going the trade remedy is a first step toward—we, after all, are the proponents. It was Franklin Roosevelt and Henry Morgenthau that pushed the idea of mutual reduction in tariff barriers. That got built into the IMF originally, through the GATT, and now through the WTO. We are the proponents of that. We pushed that. We open up, we try to help countries to become democratic. One of the things we do is we sign bilateral trade agreements with them, so we say we are going to let you come into our market, but in exchange we want to see some stability in that country.

I think we want to be very careful about throwing away a system that has worked extremely well. But I do believe that prudent people look at risks and say I do not know whether this is unsustainable forever. But at least there is a chance that it could disrupt in a crisis. Therefore, we want to take an orderly approach where we make some concessions to the world by reducing our current account deficit. And let me say that the trade deficit, the second time—we saw this in the 1980's—the budget deficit has come down; the trade deficit, the current account deficit is not coming down. There is not a one-to-one correspondence between those two things. We do need to do things which increase our saving rate. Those are long-term things, but they are very important. And that is where the President is going to have a tax reform commission which is going to come with a proposal for tax improvements, presumably to help the saving rate. The Congress should really try to look at that, take it seriously as a long-run fundamental change.

The Chinese need to do something about their exchange rate. There is no question about that. But we need to do that slowly, and they need to do it in a systematic way that affects all of Southeast Asia. That is why I think a neutral, rather less involved group like the IMF, which has responsibilities in this area, is a good place to try to negotiate these differences on a multilateral basis.

Senator CRAPO. You know, the two of you together I think have painted a pretty good picture of the positions and the arguments that are made around this issue, and, in fact, you have also raised the macro political issues that we deal with here in Congress.

I tend to think that it would be a great thing, Dr. Bergsten, if we could succeed in the arguments that you make and the strategy that is proposed here that you both support of having the IMF try to play a role in facilitating this and get the Chinese to have a one-time revaluation up to 25 percent.

On the other hand, I also tend to think that Dr. Meltzer might be right that it is not highly likely to success that they would do that.

Now, I do not know and I would love to—I certainly think we should try it. But it certainly raises the political issues that we are dealing with here in Congress. The fact is that the Chinese have been manipulating the U.S. dollar for a decade or more.

Mr. MELTZER. At great cost to them. The cost to them is something like 1 or 2 percent of their GDP every year.

Senator CRAPO. That is at great cost to us, too.

Mr. MELTZER. Well, you know, we are——

Senator CRAPO. Given things are so great here in the—I mean, there is a lot of the positive you can point out. There is a great cost here that we are paying.

Mr. MELTZER. That is right, but there is a great benefit. I mean, we get real goods and services from them, and we give them pieces of paper, which we can ultimately devalue if we wish. We are not suffering terribly as a result of this. There are local problems that come because of the wood industry, the textile industry. But to think that we are going to save the textile industry by a Chinese revaluation, that is going to have more beneficial effect on Mexico than it is on us.

Senator CRAPO. Can I assume that—and I would like you both to just comment on this again. You have both touched on it already, but I am hearing both of you say that the Congress should avoid the political pressure to impose trade barriers as a pressure to get a solution here. Am I correct there?

Mr. MELTZER. Absolutely.

Mr. BERGSTEN. I yield to no one, including even Dr. Meltzer, in my zealous support of the free trading system for 50 years. I have been working very hard on it for all my career. So, I absolutely concur with everything he said on that.

I do observe, however, as I mentioned before, that the politics underlying an open trading system are threatened when there are big macroeconomic imbalances. It could be prolonged recessions, like in the 1930's, but it could also be prolonged currency imbalances. I cited the example of the mid-1980's, when President Reagan, despite being clearly pro-market and pro-free trade, put up more trade barriers than any President in the 20th century because of the currency imbalances and the big growth in our trade deficit.

During the Reagan Administration, voluntary export quotas were foisted on Japan on almost everything—autos, steel, machine tools, you name it; other countries did so as well. Why? Because of big macro imbalances.

We were at risk of losing the open trading system, which Dr. Meltzer and I both espouse so strongly, because of macroimbalances—in that case, it was truly macro in the United States, the fiscal policy, the fiscal/monetary mix, but also the exchange rates, which threatened the system. Therefore in defending the open trading system, I will frequently emphasize taking tough measures, if necessary, to eliminate the currency imbalances.

I acknowledge that it sounds paradoxical to say I want to threaten trade controls against China to avoid the risk of putting on trade controls. That is why I want to try everything else first, and that is why I think this IMF strategy would be the way to go right now. But if at the end of the day China and the other Asian countries continue to resist any adjustment from their standpoint, we

may have to get tough. It was done in the United States in the early 1970's; it was done in the mid-1980's. It succeeded both times, with some crockery broken along the way. You prefer not to do that.

But think back to what Secretary Quarles said. He talked about the three-legged stool they have in mind for dealing with this problem, and in broad terms I agree with that. One leg is the Asian currencies. They have been trying sweet reason on their own for 2 years. It has had zero impact. The question is whether, with the step-up in U.S. action, per the Secretary's latest report, there will be some response from the Asian side. I dearly hope so. But I am also realistic enough to say there may not be. And if they move, it might be a token step, and you might not get any significant adjustment out of it.

So it is not just that they move but the move be big enough to have a discernible impact. If they—China but also the rest of Asia in part, using China as a justification—continue to resist, then we face the choice of either letting the imbalances get bigger, building the financial risks, and clearly increasing the risks to the open trading system or trying to deal with the problem, even if it means taking the gloves off. I resist that. I prefer not to do it. But sometimes in the real world you have to go that way.

Senator CRAPO. Dr. Meltzer, what if we try this and it does not work? Can we still face the Chinese manipulation of the dollar?

Mr. MELTZER. We have the ultimate weapon which we have, which is we can inflate and wipe out most of that debt. So that is a weapon that we have. That is certainly not a weapon that I recommend, but before I brought down the international trading system, I would certainly think about what other weapons there were in the arsenal.

Let us go back and before we make a crisis out of this problem, let us go back and Think through. We receive valuable goods and services from the Chinese, including things which help us keep the cost of manufactures down, as well as the cost of consumer goods. In exchange for that, we give them pieces of paper. That is a great system for us because it does not cost us anything to print those pieces of paper, and we get real value for it.

Now, what makes it a problem? It becomes a problem because there are many people who believe that it is unsustainable, that it cannot go on, and, therefore, we should do something about it. But before we use the sledgehammer, we ought to go slowly. So that is why I describe this as a risk. There is a risk that people who are—I am not convinced, but there is a risk that the people who say that this is a problem will be right. Therefore, a prudent man says, well, let us take some steps in the direction of correction. And what are some ways of doing this? Well, we have tried. I think the Chinese have certainly moved—I do not think that it is correct, as Fred says, to say that the Treasury's patience has been completely lost and nothing has happened. I think the Chinese have heard from us, from the Europeans, from others, and they are moving.

They never give the date and the action in the same sentence, so we never know whether there is going to be a Chinese move. But I think that they have gotten the message.

There is always a question in negotiations of this kind whether, if you are quiet and not aggressive, you get more action than you do if you are too aggressive. I mean, the Chinese are proud. They are not likely to revalue their currency because we ask them to or we demand it of them. So that is why calm negotiation which deals with the risk of this problem over a longer period of time, which says, you know, what do we want? A one-time revaluation of the Chinese renminbi? No. I would like to see Chinese put on a path which would move them toward a floating exchange rate. That is not so hard for them to do, and they know what they have to do. They have to improve their banking system. Well, they have $700 billion worth of bonds. They could shore up their banking system to some extent. What they need to do is to make the internal changes, which are very important, and not keep building up the bad loans of the banking system and using that as an excuse for not being able to move their currency. So we want to move the negotiations so that they look at their problems and we look at our problem.

Senator Bayh talked about, sort of alluded to the fact that Argentina had run a big deficit. The United States is in a peculiar position. Its debt is all in dollars. Argentina's debt was in dollars. But we can produce dollars, so that puts us in a unique position in the world, and it is probably that more than anything else which keeps us from having a crisis now instead of a problem. So I say we do want to go to some neutral agency; we do want to negotiate. Fred and I agree about that. But we want to make really major moves on both sides—here to increase the saving rate, there to shore up the financial system and float the exchange rate.

Senator CRAPO. Well, like Senator Bayh, I am starting to run into some time pressures now, too. I know that both of you also have a lot more to say. Dr. Bergsten, I know you were trying to get in there. Can you just say it in a couple of minutes?

Mr. BERGSTEN. I must admit I was shocked to hear Dr. Meltzer, who has written a definitive study of the history of U.S. monetary policy, suggest we might respond to this by inflating our debt away.

Mr. MELTZER. We have been known to do that.

Mr. BERGSTEN. But I certainly do not advocate it, and I know you do not.

Mr. MELTZER. I did not.

Mr. BERGSTEN. The trade measures I would contemplate, even as a last resort, would be much less costly to the United States and the world economies than for the United States to go on an inflationary binge to, in that sense, devalue the currency and inflate away our debt. So, I would not go that way.

Mr. MELTZER. I do not recommend that. I just said that is an alternative to the things that you were talking about, which would be to bring down the world trading system.

Mr. BERGSTEN. A decidedly inferior approach, and mine would not bring down the trading system. Mine would seek to defend the trading system.

A final point. Timing is crucial, as you were emphasizing, Mr. Chairman. Dr. Meltzer says go slowly. The Treasury has been going slowly for 2 years. I do not think it has much to show for it other than a bunch of very small technical changes in the way

the Chinese run their financial system. By the Chinese' own testimony, it is going to be many years before they are ready to move to a flexible exchange rate. When I asked them about this over the last 2 or 3 years, they said, well, around the time of the Beijing Olympics in 2008. That is only 3 years away now but it is still pretty long, as these things go. And my guess is it will be 5 to 10 years before their banking system and the rest of their economy is in shape to really support a true floating exchange rate system, which means elimination of most or all of their capital controls.

That is not at all feasible on the kind of time horizon that I worry about in terms of domestic political unsustainability as well as international financial unsustainability.

We have tried for 2 years. It has not gotten anywhere. I do not want to wait 5 to 10 more for the Asians to move. I am afraid all hell will have broken loose on both the financial and trade sides long before that. Therefore, I want to think about what has admittedly been the unthinkable of taking tougher actions.

But before I get there, I do not know why we do not mobilize the existing institution to defend its existing rules, which are clearly being violated. That is a no-brainer, and it seems to me the Committee ought to push hard for that.

Senator CRAPO. And it seems to me the two of you agree on that.

Mr. MELTZER. We do.

Senator CRAPO. I want to thank you both for coming today, and you always provide us with not only a lively interchange, but with some very significant debate about very tough issues. I appreciate you coming before us again to do that, and I think you have given this Committee and this country some very good ideas about how to proceed.

Thank you very much for coming.

Mr. MELTZER. Thank you, Mr. Chairman.

Mr. BERGSTEN. Thank you, Mr. Chairman.

Senator CRAPO. This hearing is adjourned.

[Whereupon, at 11:47 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF RANDAL QUARLES

ACTING UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

JUNE 7, 2005

Thank you Chairman Crapo, Ranking Member Bayh, and other Members of the Subcommittee. I am pleased to be here today to talk about our agenda as a shareholder of the International Monetary Fund (IMF).

Reform of the IMF has been a high priority since the start of the first Bush Administration. Former Under Secretary John Taylor appeared before the full Committee last May and summarized our work to date in both the IMF and World Bank. He laid out the underlying rationale for our quest to update these institutions—noting the growing role of international debt securities, the increase in the volume of private capital flows, and the increasing interconnection between financial markets. As he said at the time, those factors, combined with the crises of the late 1990's, made abundantly clear that greater predictability, accountability, and more systematic behavior on the part of the official sector were vital to enhance the international financial policy framework.

The Path of Reform

The International Financial Institutions Advisory Commission (IFIAC), chaired by Dr. Allan Meltzer, helped provide impetus for reform. The Commission's report in March 2000 provided important insights about how the IMF and other international financial institutions could better realize their goals. The Commission's recommendations contributed to a serious debate about IMF reform, in which this Committee was an active participant. With strong advocacy from Treasury, the IMF has acted on reform. Specific steps by the IMF have been detailed in a series of annual reports to Congress—most recently in October 2004. Let me summarize some of the highlights over the last 5 years:

- The international community has clarified the limits and criteria for large-scale official sector lending. Consistent with the Meltzer recommendations, there has been no quota increase in the IMF. With IMF liquidity at historic highs, there is no need to add to its resources. Further, we have encouraged the presumption that the IMF, rather than governments, is responsible for providing large scale loan financing in the face of crises. With IMF resources limited, this presumption provides an overall budget constraint and thereby an overall limit on loan assistance. Further, requests for large loans that represent exceptional access to IMF resources now face new procedures, including a higher burden of proof in the form of a special report that documents how IMF financing will support strong policies in the borrowing country.
- IMF programs are now more focused on its core macroeconomic areas of expertise. In work on lending programs, the IMF is more tightly focused on its core areas of monetary policy, fiscal policy, the balance of payments, exchange rates, and the financial sector. Further, the IMF relies more heavily on more robust analytical tools, particularly for risk assessment, enhancing its capacity to anticipate and deter financial crises.
  - We achieved changes to reorient IMF lending to focus more on short-term financing, discourage casual or excessive use, and provide incentives to repay as quickly as possible. This includes higher interest rates for higher levels of access to discourage excessive reliance on Fund resources. It also includes limited use of Extended Arrangements, to reinforce the focus on making resources available only for the short-term. These changing incentives are having an effect.
  - The IMF is much more transparent than it was 5 years ago. Seventy-eight percent of staff reports for lending arrangements and Article IV's are made public. The IMF provides extensive information publicly about its financial operations. And the IMF has a permanent, independent evaluation office that has been producing high-quality reviews of specific IMF policies and activities.
- As part of the effort to correct incentives and prepare for more effective resolution of crises that occur, there has also been a major step forward on making the process of restructuring sovereign bonds more orderly. In that regard, the Administration worked closely with other countries to make routine the use of collective action clauses (CAC's) in sovereign bond documentation to promote orderly restructuring and reduce disruption. One year after the launch of this initiative, Mexico responded by including CAC's in its New York law governed bonds. Brazil, Korea, South Africa, and Turkey soon followed, and inclusion of CAC's quickly became standard market practice.

These are major steps forward. Yet we are not prepared to relax our efforts. More needs to be done to ensure that the IMF is positioned for the challenges off the 21st century. In partnership with the G–7 and others, the United States has called for a strategic review to identify changes needed to make the IMF (and the World Bank) more responsive, relevant, and helpful to their members. The IMF has taken up this charge and is now undertaking a review of its role and strategy for the medium term.

Pushing the Next Wave of Reform—U.S. Priorities

Like any other institution, the IMF must continually examine itself to make sure that it is doing the best it can to achieve its core objectives. Fostering international monetary cooperation and balance of payments adjustment to support international financial stability and economic growth clearly remains its key aim. The purpose of this review is to make sure the institution is doing all it can to advance this goal.

As we engage in this review with other members of the IMF, the United States has several key priorities: Strengthening IMF surveillance and crisis prevention; creating a more effective way for the IMF to actively support strong policies without lending; and realigning the IMF's role in low-income countries to achieve better results. Let me explain what we have in mind in each of these areas.

Strengthening Surveillance and Crisis Prevention

The IMF's core mission is to oversee the international monetary system to ensure its effective operation, and for that purpose to exercise surveillance of the macroeconomic and exchange rate policies of its members. In this way the IMF should help prevent crises and foster adjustment in global imbalances.

This process offers the IMF a unique opportunity to assess risks, influence policy, and help prevent crises. Indeed, surveillance has proven a very useful tool. Yet the execution of surveillance needs further enhancement. Action is needed, for instance, to further tighten the focus and selectivity of analysis. We also believe that the IMF needs to integrate more fully capital market and financial sector analysis into the daily life of the Fund. In addition, the IMF has a critical role to play in exercising firm surveillance over its members' exchange rate policies to promote international adjustment. In recent months, the IMF has called for multilateral actions, including greater exchange rate flexibility in emerging Asia, and particularly in China.

Promoting Strong Policies without Lending

The IMF has traditionally had two levels of engagement with member countries—either the IMF reviews economic performance and policies annually through surveillance or, at the member's request, the IMF provides financial support conditioned on implementation of economic reforms that the IMF helps design and monitor. There is no middle ground between routine review and conditional finance.

The United States strongly believes that the IMF needs a new tool to provide for structured engagement in support of strong economic policies where there is no need for borrowing. We have proposed a new nonborrowing program to serve this role. Participation would be voluntary for member countries. The process of laying out an economic program would be led by each participating country, with the opportunity for country authorities to engage closely with IMF staff as they work to strengthen their country's macroeconomic policy framework and macroeconomic institutions.

The proposal now has the support of our partners in the G–7, and we expect it to be taken up by the IMF's Executive Board this summer. Demand for such an arrangement is already emerging from IMF member countries. We expect that some countries may actively seek to convert their borrowing relationship with the IMF to this basis and that others will welcome such a nonlending arrangement once their existing program expires, as a way of maintaining a signal from the IMF about the strength of their economic policies. This signal could be particularly useful to countries with strong macroeconomic foundations that nonetheless continue to depend on other donors for development financing or that are transitioning to market-based financing away from development finance. And it should help protect IMF resources for those countries with specific balance of payments needs.

Supporting Low-Income Countries Effectively

Low-income countries face enormous economic and development challenges. Engaging with these countries to help them achieve macroeconomic stability—through policy advice, technical assistance, and financing when appropriate—is a vital part of the IMF's mission. Yet the Fund is not a development institution, and its financial operations should reflect its mission to provide short-term balance of payments financing rather than longer-term development aid.

While there is disagreement among economists about the impact of IMF assistance on economic growth in low-income countries, the growth performance of many of these countries has been disappointing over the past two decades. A central challenge for the IMF is to improve the effectiveness of its own engagement in low-income countries to help them achieve sustained improvement in economic outcomes.

Prolonged use of IMF resources is a serious problem, particularly for low-income borrowers, and is exacerbated by the Fund's practice of rolling-over existing exposure. Nearly all (30 of 32) countries with PRGF programs at the start of 2005 had at least two prior PRGF arrangements, each of which lasts 3 years. Prolonged reliance on IMF support can impede domestic ownership of economic policies and the development of institutions and can blur the IMF's short-term balance of payments role versus the longer-term development finance role of the MDB's.

We have encouraged the IMF to undertake a close examination of its approach in low-income countries—with a view to helping these countries achieve better economic results. Good economic policies are fundamental to the efforts of low-income countries to increase economic growth and improve the lives of their citizens. The IMF needs to find a way to support good policies more effectively, and in a way that is consistent with its role as providing temporary and short-term assistance in response to balance of payments shocks.

As a top priority, the IMF needs to establish and maintain high standards for its support for countries' economic programs. Weak or half-hearted policy efforts should not merit IMF financial support, in emerging markets or low-income cases.

When countries are pursuing strong policies, the PRGF should be flexible enough to respond to countries facing short-term adverse developments in their balance of payments. The PRGF also needs to be available to support needed macroeconomic reform over the medium-term. It should not, however, be geared to provide long-term development finance. Indeed, we believe that the proposed nonborrowing program that I have described for you above would offer a particularly important tool for low-income countries that have progressed through stabilization and no longer need to rely on IMF financing.

And perhaps most important, helping low-income countries depends on ending the lend-and-forgive cycle, so that they can move into an era of sustainable debt. The IMF has recently implemented a new debt sustainability framework, which establishes new standards for determining whether countries can or should take on additional debt.

It is critical that the IMF and other lenders integrate this framework into their operations. This, along with increased use of grants in IDA and the AfDF, as well as further bilateral and multilateral debt relief in those institutions for the HIPC countries, can provide a clear path to end the cycle of repeat lending and debt problems holding back the poorest countries.

With respect to debt relief, the Bush Administration has put forward a bold proposal that would relieve the debt burdens of poor countries. The proposal calls for immediate action to provide up to 100 percent relief on IDA and AfDF loans to the Heavily Indebted Poor countries (HIPC's). Action on this debt is critical to putting these poor countries on a sustainable path.

Any debt relief in the IMF would need to be financed from existing resources in the IMF.

We do not believe that gold sales—whether they were to be executed in the market or "off-market"—are necessary or warranted. I know that the issue of gold is of particular interest. Treasury has repeatedly voiced our opposition to a sale of IMF gold. Gold provides important underlying strength to the IMF's financial position. Selling IMF gold requires an 85 percent majority vote; since the United States has a 17.1 percent voting share in the IMF, our agreement is required before such a sale can go forward. Congressional approval is required for the U.S. Executive Director to vote in favor of such an IMF gold sale.

Modernizing the IMF's Governance

The IMF is accountable to its 184 member governments through a weighted voting structure aligned with countries' global economic standing. However, change in the world economy has outpaced that in the IMF's voting structure, particularly given fast-paced growth in emerging market economies and integration in Europe.

We feel strongly that the IMF is a financial and shareholder institution the governance of which should evolve along with the world economy. If countries are growing strongly and making increasing contributions to the global economy, then there should be a parallel enhancement of their position in the IMF. This is vital to maintaining the goodwill of members, on which the IMF relies to make its lending possible, and to preserving the centrality of the IMF in the global financial system.

Beginning in October 2004, Secretary Snow has emphasized that change is needed to address the growing disparity between the IMF's governance structure and the realities of the world economy. In April, he took a further step when he asserted that it is time to examine these issues now—and that progress should not, and indeed need not, be linked to an increase in the IMF's quota resources, which is not necessary given the current strength of the IMF's financial position. In particular, he has suggested that shifting quotas within the existing total could yield substantial progress. This could allow for quota shares to reflect the advent of monetary union in Europe and the increasing role of fast-growing emerging markets, especially in Asia.

Change will not come quickly or easily. The issues are complex, and extensive dialogue and cooperation will be needed to find a way forward. Yet we believe the effort is worthwhile—and indeed essential to the long-term effectiveness of the institution. An IMF for the future must be an IMF in which all have a stake.

Argentina

One of the important tasks that has faced the IMF over the last 4 years has been dealing with the situation in Argentina, so let me say a few words about Argentina's economy and engagement with the IMF.

The Argentine economy continues to recover from the sharp contraction that accompanied the 2001–2002 financial crisis. Real GDP grew 9 percent in 2004, following growth of 8.8 percent in 2003. Inflation ended 2004 at 6 percent after spiking to 41 percent at the end of 2002. The exchange rate has been roughly stable since mid-2003 and reserves have grown $11.5 billion since the end of 2002.

These positive results have been underpinned by better macroeconomic policy since the crisis. The Federal Government increased its primary surplus to nearly 4 percent of GDP in 2004 from a zero balance in 2001. Monetary policy succeeded in limiting the growth of the money supply to prevent an upward inflationary spiral.

The United States has supported IMF engagement with Argentina through the transitional program launched in January 2003 and the 3-year program launched in September 2003. The purpose of these programs was to lock in macroeconomic stability and attack impediments to growth. Essential reforms include addressing Argentina's chronic fiscal problems related to Federal-provincial fiscal relations and weak tax administration, restoring the health of the banking sector, and improving the investment climate. The IMF program helped establish a basis for facilitating the normalization of Argentina's relations with its external creditors.

Argentina's performance under the 3-year program has been mixed. Argentina has continued to perform strongly on its macroeconomic targets. However, we still have concerns regarding the implementation of its structural policy commitments under its IMF program. The IMF has not made any disbursements to Argentina since March 2004.

With respect to the debt restructuring, in January 2005 Argentina launched a debt exchange offer to restructure its $82 billion in principal claims of defaulted debt. Over 76 percent of creditors accepted Argentina's offer, while 24 percent (representing $20 billion in principal claims) did not.

With the recent settlement of the debt exchange, Argentina is now returning its focus to negotiating a new arrangement with the IMF. A key issue will be the development of an Argentine strategy to resolve the rest of the defaulted debt. There are a number of possible ways Argentina could do this, but it is important for Argentina to be clear about how it will proceed.

In addition to completing its debt restructuring, Argentina also needs an economic program that supports sustained growth so that it can continue to raise living standards and meet its financial obligations. Sustained growth requires improving the investment climate in order to attract private capital. Resolving the situation in the utilities sector will be an especially important signal to investors in this regard. Growth also requires locking-in fiscal improvements by fixing Federal-provincial fiscal relations to prevent the provincial overborrowing that contributed to the 2001 financial crisis. Finally, continued strengthening of the banking sector will be important for providing the credit Argentina needs to grow. Key reforms in the banking sector include completing bank compensation, which Argentina has made further progress on in the past month, defining the role of public banks in the banking sector, and continuing with the defined path of regulatory reforms.

Conclusion

I appreciate the opportunity to reflect on the path of IMF reform and lay out for you the Administration's priorities as we continue to press change in this vital institution. I believe that important progress has been made. Yet there is more to be

done to ensure that the IMF operates effectively in the 21st century. I hope my remarks today make clear our commitment to maintain the momentum of reform.

I welcome your questions.

PREPARED STATEMENT OF ALLAN H. MELTZER

THE ALLAN H. MELTZER UNIVERSITY,
PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY AND
VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

JUNE 7, 2005

Mr. Chairman and Members of the Committee: It is a privilege to have this opportunity to review progress on reform of the International Monetary Fund (IMF). I commend the Chairman and the Members for their continued interest.

I am pleased to report that there has been progress on central issues. On other important issues, much is unfinished, and in some cases, unstarted. From the comprehensive list of topics proposed by your staff, I have chosen to discuss progress toward the adoption of recommendations of the Meltzer Commission, but I touch on other questions that the staff raised.

In the view of the Meltzer Commission, the IMF has two main tasks. Its most important activity is to increase the stability of financial markets or, if crises cannot be prevented, to localize problems or crises and keep them from spreading to countries or markets that would be unaffected. A related but distinct activity is to reduce market risk by improving the quality and increasing the quantity of information available to lenders and creditors.

The IMF has made a sustained effort to improve the quantity and quality of information on member countries. More is desirable. Especially needed are reductions in the time before information becomes generally available.

A remarkable change came to fruition this year. Argentina settled its defaulted debt with about 75 percent of its bondholders. This was the largest default ever, and it involved tens of thousands of individual debt holders and many separate debt issues. Coordination did not, at first, seem promising, but it was achieved without outside intervention.

Unlike earlier practice, the IMF was not a party to the negotiations. It did not make additional loans to Argentina to assist in the settlement and bailout the lenders. The settlement was based on decisions between the Argentine Government and representatives of the bondholders. I am confident that in time, Argentina can settle with the remaining bondholders without IMF intervention. I consider this a big step forward because risks and returns were related. Lenders who received high interest rates on risky loans had to bear the risk when it came. This improves the functioning of markets and spares taxpayers from paying for lenders' errors of judgment.

Also Argentina's financial problems were mainly confined to Argentina. When they threatened to spread to its neighbor, Uruguay, the IMF arranged a large loan. This is keeping with its principal function—preventing the spread of crises.

In its response to Argentina and Uruguay, the IMF followed the spirit and often the letter of the Meltzer Commission recommendations. It was not always so. The Meltzer Commission made two unanimous recommendations. The first called for writing off "all claims against heavily indebted poor countries (HIPC's) that implement an effective economic and social development strategy." The second called on the IMF to limit its lending to short-term loans leaving long-term loans for poverty reduction to others. Instead, the IMF created the Poverty Reduction and Growth Facility (PRGF). The IMF had no special expertise in economic development and poverty reduction. These problems should be left to the World Bank. While I agree with those who say that the development banks are ineffective, unfocussed, and should be thoroughly reorganized, duplication of their work at the IMF is not the right solution. The PRGF should be closed.

The IMF, the World Bank, and the G–7 countries have not agreed on rules for debt relief for several of the heavily indebted poor countries (HIPC). Some agreements have been made, and countries have agreed to use the resources released thereby for education and health. Great Britain is pressing for new agreements at the 2005 summit in Scotland.

Part of the discussion of debt relief is misleading. The HIPC countries do not actually service most of their debt. To prevent default, the IMF lends the country enough to make payments, increasing the countries' indebtedness. A HIPC country receives credit for payment but little or no new money. Debt relief, as usually discussed, is actually a way of increasing HIPC country borrowing. It would increase

the countries' available resources, since debtors would receive the same payment but would not have it offset by a debt service payment of similar size to the IMF. The net transfer would increase.

The main issues in current discussions are how the transfer should be financed and how the increased net transfer should be used to improve social and economic conditions. Gold sales by the IMF are one option that has been proposed. As you know, the Congress wisely disallowed the sale of the U.S. gold deposit at the IMF without its consent. The gold should be returned to the members and revalued by them. Part of the profit could be used to reduce HIPC debt.

One of the Meltzer Commission's main recommendations called for replacement of conditional loans with loans based on a limited number of preconditions accepted in advance by the troubled country. The purpose of this proposal includes reducing risk, increased incentives for reform, and giving the borrowing country a large part in the choice of policies. To its credit, the IMF has reduced substantially the number of conditions attached to its loans. It considered, but did not adopt, preconditions. As part of the comprehensive review of its strategy that is now underway, it proposes that future lending should be "anchored in strong country ownership." (IMF Survey, 34, number 7, April 25, 2005, 105)

This is a good step away from the command and control of the 1990's based on the so-called Washington consensus. "Ownership" means that the country has a major role in the choice of policies. Much evidence suggest that reform is made more likely when political leaders in the country choose it, support it, and decide to implement it. The Fund's own research suggests that much of the time countries did not implement the conditions to which they agreed to get a loan.

Preconditions reduce risk in other ways. Countries that avoid pegged but adjustable exchange rates, improvident fiscal and inflationary monetary policies, and weak financial systems are more prone to crisis. Reducing or removing these sources of instability reduces the chance of a crisis. Further, negotiated preconditions accepted in exchange for a commitment to assist in a crisis reduce the long delay that often occurs before assistance is given.

A critical part of this proposal is that countries would have greatly increased incentives to reform. If they did not agree to preconditions, they would not be eligible for assistance. This, alone, increases the incentive for reform. But this incentive increases because lenders would distinguish between countries that adopted reforms and those that did not.

The international private capital market is the principal supplier of loans. It offers 5 to 10 times the volume offered by international financial institutions. The private market would offer more loans at lower interest rates to countries that adopt preconditions. Reformers in the countries could replace arguments claiming the IMF requires reform with citation of the benefits to the country, more capital at lower interest rates.

The IMF faces many possible challenges. Will other countries follow Argentina by defaulting and renegotiating debt? Will recognition of increased risk reduce the amount of lending? Does the large accumulation of reserves by Asian countries, and other recent changes, signal a decision by these countries to manage future crises without the IMF? Have the Asian countries taken a further step toward development of a regional financial bloc? If the IMF no longer bails out private lenders, will the private lenders object to the IMF's preferred creditor status?

The IMF's loans are heavily concentrated in the debts of a small number of countries. Will one or more of these countries default on the IMF?

We should recall that the IMF's original purpose included monitoring and maintaining a fixed exchange rate system. The IMF should take more responsibility for the exchange rate system to adjust under or overvalued exchange rates. It is well-known that if more countries allowed their exchange rates to adjust, there would be fewer crises. Many observers claim that undervalued Asian exchange rates and the large U.S. current account deficit will end with a major financial crisis. They use the word "unsustainable" when they discuss the U.S. current account deficit. I am far from certain, even skeptical, about these claims. But we should recognize that there is a risk that will not be removed and may be increased, by an appreciation of China's exchange rate. In keeping with its original purpose, the IMF should try to implement a cooperative solution that revalues the yuan and reduces the U.S. deficit.

Finally, corruption is a major problem in some developing (and developed) countries. No one can rid the world of bribery and corruption, but the IMF could do more than it now does to limit corruption.

PREPARED STATEMENT OF C. FRED BERGSTEN

DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

JUNE 7, 2005

It is a pleasure to testify before the Committee again concerning your ongoing oversight of the International Monetary Fund. The topic remains of great importance and our Institute for International Economics will in fact be holding a major conference on IMF reform on September 23 to address a number of specific proposals for strengthening and enforcing the rules of the monetary system, improving the governance of the Fund itself, reforming its lending programs, and reassessing the ways in which it might be financed in the future. All Members of the Subcommittee and staff are cordially invited to participate in our event!

Exchange Rates in China and East Asia

The most important and urgent issue facing the international monetary system and the IMF at the present time is the huge imbalance in major national economies and exchange rates. The global current account deficit of the United States is very large (nearing an annual rate of $800 billion, almost 7 percent of our GDP) and growing rapidly. The global current account surplus of China is very large (over $100 billion this year, about 6 percent of its GDP) and also growing very rapidly. A number of other Asian countries—most notably Japan but also Korea, Taiwan, Hong Kong, Singapore, and Malaysia—are also running substantial global surpluses that are the counterparts of the U.S. global deficits.

We in the United States must lead the correction of these imbalances by raising our rate of national saving so that we will not be so reliant on inflows of foreign capital—which we must now borrow at the rate of $5 billion every working day—and thus condemned to run the counterpart current account deficits, which generate enormous pressures for trade protection (which are now being rapidly realized, especially against China) as well as huge international financial risks. This requires a combination of restoring the budget surpluses that we were running just a few years ago, to reduce public dissaving, and increasing our pitifully low rate of private saving.

One essential element of the global correction will be a further large decline in the exchange rate of the dollar, probably by at least 20 percent on a trade-weighted average against the currencies of our major trading partners. The dollar has already declined substantially against the currencies that float freely in the exchange markets: Notably the euro, pound, Swiss franc, Canadian dollar and Australian dollar. The next phase of the dollar's decline needs to take place against the currencies of the East Asian countries that are running the world's largest surpluses and have the world's fastest growth rates—but have intervened massively in the exchange markets to block any appreciation of their currencies at all (China, Malaysia) or to limit that appreciation far below what market forces would have produced.

China is the key country. Its surplus is now the largest among the major Asian economies as a share of its economy. It has been *increasing* its competitiveness by riding the dollar down against most other currencies, thus achieving a trade-weighted depreciation of about 10 percent over the past 3 years. Moreover, the other Asian countries (from Japan to India) are terrified of losing competitive position against China so will resist the rise of their currencies against the dollar as long as doing so also means rising against the renminbi. The need for appreciation of the Asian currencies is particularly acute from a U.S. standpoint now that the euro, which had risen 65 percent against the dollar from its lows of late 2000 to its peak earlier year, is under downward pressure as a result of the apparent rejection of the proposed constitution for the European Union.

It is the responsibility of the International Monetary Fund to take the lead in promoting correction of such huge, costly, and potentially destabilizing imbalances in the world economy. The Fund's Articles of Agreement in fact enjoin member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other member countries" (Article IV, Section 1, paragraph iii). In 1977, early in the era of floating exchange rates, the Fund laid out principles for its surveillance over members' currency policies that identified "protracted, large-scale intervention in one direction in the exchange markets" as indicating a need for Fund discussion with the offending country.[1]

[1] A complete analysis of this issue can be found in Morris Goldstein, "The International Financial Architecture," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade (Institute*

China clearly meets these criteria. (So does Malaysia and so would have Japan until it ceased its massive intervention a little over a year ago.) Our own Treasury indicated as much in its latest semiannual report to the Congress, after white-washing China's behavior for several years and still inexplicably failing to label it explicitly as a "currency manipulator" as called for under the relevant statute of U.S. law.

The International Monetary Fund, however, appears to have limited its activity on this issue to quiet efforts to persuade China to reform its currency *regime* (as opposed to raising upward its exchange *rate.*) It apparently was unwilling to endorse the critique of China's policy in the latest Treasury report, incomplete as that was.

The Fund is of course a creature of its major member countries, especially the United States and the rest of the G–7, so the responsibility lies with those governments at least as much as with the institution itself. Part of the problem is that the U.S. Treasury and the rest of the G–7 have, at least until very recently, been proposing the wrong thing: They have been asking the Chinese to float their exchange rate, which is neither desirable (because it might float down, worsening the current account imbalances) nor feasible (because the Chinese banking system is far too fragile to support anything resembling a true float, especially with a sharp reduction in China's capital controls), rather than for the sizable one-shot revaluation of perhaps 25 percent that is essential to make a substantial contribution to reduction of the global imbalances.[2]

The Fund, with its systemic and global responsibilities, should nevertheless have been making a much more forceful and much more pragmatic effort to bring the global imbalances back under control. To its credit, it has been vocally pushing the United States to initiate (especially budget) actions that would reduce its external deficits. It has likewise been urging the Europeans to implement structural reforms to accelerate the growth of domestic demand in their economies, to offset the adverse impact they will experience from the declines in their trade surpluses that are an essential counterpart of reduction in the U.S. deficits. Without much stronger support from the G–7 countries, however, notably including the United States itself, there is little that the Fund can do to achieve realization of such policy alterations—including with respect to the Chinese and other East Asian exchange rates.

Argentina

Another key question facing the IMF at present is its relationship with Argentina as that country emerges from its traumatic depression and debt crisis. The Fund badly mishandled Argentina virtually throughout the run-up to that crisis. It endorsed the country's rigid currency peg, even as it was becoming increasingly overwhelmed, and failed to insist on fiscal tightening during the boom period of the middle 1990's, setting the stage for the escalation of budget deficits and debt that brought on the biggest default in modern history when things turned sour. It then prolonged and deepened the agony by lending large amounts that enabled the Argentine authorities to further postpone the policy changes whose necessity had become blindingly obvious.[3]

At the same time, the lessons of the Argentine crisis for the international monetary system and the IMF are not yet clear. Argentina itself is recovering briskly. It is now receiving so much foreign investment that its currency is rising and it has recently adopted restraints on capital inflows. The global financial system suffered little contagion from the Argentine episode, despite the country's being both the largest borrower among emerging market economies and engineering the largest sovereign default in modern history. Emerging market economies are receiving near-record capital inflows so no significant "chilling effect" can be discerned at least for now. The apparent "success" of the Argentine default strategy does not seem to have tempted other countries to pursue a similar strategy and Brazil next door has in fact been a model of rectitude even under the Lula Government.

All these results will of course need to be stress tested during the next global economic downturn and sharp rise in world interest rates before firm systemic conclusions can be drawn. One close observer of the process concludes that "Argentina's crisis has done little so far to validate or discredit the idea of statutory sovereign

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for International Economics, 2005.) Goldstein also suggests a number of other important IMF reforms that should be pursued in the near future.

[2] Our estimate at the Institute for International Economics is that a Chinese revaluation of 25 percent and upward appreciations of one half that much by the other East Asian countries would reduce the U.S. current account deficit by about $60 billion after the full effects phased in over two to 3 years. The U.S. gain would be at least $100 billion if the exchange rates of the other Asian countries rose by the full amount of the Chinese move.

[3] The full story is in Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Institute for International Economics, 2002.)

bankruptcy" but adds that "It achieved impressive debt relief in a reasonably short timeframe without either CAC's (collective action clauses) or bankruptcy." [4]

Debt Relief and IMF Gold Sales

Another operational issue confronting the Fund is whether to relieve some of its poorest member countries of their debt to the Fund itself (now about $6 billion for the forty or so countries identified as Heavily Indebted Poor Countries, or HIPC's) and, if so, how to finance the resulting impact on the Fund's balance sheet. The most promising candidate is use of the Fund's own gold reserves, which are worth more than $40 billion. A limited version of this idea, which enabled the Fund to mobilize profits on its gold holdings without actually selling any of them into the market, was actually implemented in 1999 and yielded about $2 billion for debt relief.

There is considerable debate over the desirability of debt relief as a mechanism for providing assistance to poor countries. Whatever the economics of the issue, however, it is clear that this particular channel attracts more political support than most other methods of providing foreign aid. In addition, our own careful study of the issue suggests that debt relief has a number of advantages over more traditional forms of aid: Increasing ownership of their development program by poor countries because of their greater autonomy in using the funds, reduced transaction costs, increased fungibility and hence utility of the resources, elimination of tying, and freeing donor countries of the need to extend new aid to the debtor countries simply to finance repayments of existing debt. We advocate several important changes in existing debt relief techniques but support the basic strategy, including through mobilization of another portion of the IMF's sterile gold stockpile.[5]

A related issue is whether the IMF should continue to lend to the world's poorest countries through its Poverty Reduction and Growth Facility (PRGF). This is one of the few issues, along with the desirability of comprehensive debt relief itself, on which there was unanimous agreement among the members of the Meltzer Commission: that the IMF should get out of the business of making poverty reduction loans. My own proposal, however, is not to eliminate the PRGF but rather to transfer it to the World Bank, whose primary mission is poverty reduction in poor countries. This would *inter alia* clear the decks for the IMF to extend debt relief to those poor countries without placing itself in the self-contradictory position of then extending new loans to the very same countries that had just been judged incapable of paying their existing debts.

Meltzer Commission Report

These were among the very few issues, however, on which there was agreement on the Meltzer Commission. I have testified to this Subcommittee or the full Banking Committee on these differences on a number of occasions including in March 2000 upon the release of the Commission's report, in April 2000 and most recently in May 2004. As the author of the dissenting minority report, I am pleased that the U.S. Treasury and the G–7 Finance Ministers rejected the main proposals of the majority almost immediately and that those proposals mercifully enjoyed a very brief period of serious consideration.

Suffice it to note today that the majority's proposals look even worse in retrospect, if that is possible, than they did when issued. They would clearly not have precluded the mistaken program for Argentina described above because Argentina, which was (mistakenly) the Fund's "poster child" for much of the 1990's, would almost certainly have been deemed to meet the majority's requirements for prequalification for Fund assistance. Former IMF Chief Economist Michael Mussa notes that "On the criterion of having a sound banking system, with widespread participation of foreign banks, Argentina was clearly outstanding . . .and it was particularly praised in this regard by one of the members of the Meltzer Commission majority. Presumably, on those grounds (my note: Which were the majority's *chief* criteria), under the Commission's proposals, Argentina would have qualified for a very large package of precommitted support." [6]

On the other hand, the Meltzer Commission majority's requirement would almost certainly have precluded the very successful Fund program for Brazil (and the program for Turkey, whose ultimate outcome is less clear but which has succeeded to date). Their proposals to shut down several major sources of funding for poor countries, including the regular lending program of the World Bank, fly in the face of

[4] Anna Gelpern, "What Bond Markets Can Learn from Argentina," *International Financial Law Review,* April 2005.
[5] The full analysis is in Nancy Birdsall and John Williamson, *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture* (Center for Global Development and Institute for International Economics, 2002.)
[6] Mussa, Argentina and the Fund, p. 73.

the revealed preferences of virtually every rich country in the world (including our own, in both the Administration and the Congress) to sharply increase the flow of resources to counter poverty and underdevelopment. I hope we can focus today's discussion on issues of current and future relevance rather than rehashing stale debates that were closed out for all practical purposes half a decade ago.